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INDIANA UTILITY
REGULATORY COMMISSION

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF INDIANA MICHIGAN POWER COMPANY, AN INDIANA CORPORATION, FOR AUTHORITY TO INCREASE ITS RATES AND CHARGES FOR ELECTRIC UTILITY SERVICE, FOR APPROVAL OF: REVISED DEPRECIATION RATES; ACCOUNTING RELIEF; INCLUSION IN BASIC RATES AND CHARGES OF THE COSTS OF QUALIFIED POLLUTION CONTROL PROPERTY; MODIFICATIONS TO RATE ADJUSTMENT MECHANISMS; AND MAJOR STORM RESERVE; AND FOR APPROVAL OF NEW SCHEDULES OF RATES, RULES AND REGULATIONS.	)	**CAUSE NO. 44075**

PETITIONER'S REPLY BRIEF IN SUPPORT OF PROPOSED ORDER

Petitioner Indiana Michigan Power Company submits the attached brief in support of its Proposed Order.

Respectfully submitted,

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PETITIONER'S REPLY BRIEF IN SUPPORT OF PROPOSED ORDER

Indiana Michigan Power Company ("I&M" or "Company"), by counsel, hereby replies in support of its Proposed Order, to the post hearing filings of the Office of the Utility Consumer Counselor's Proposed Order ("OUCCPO"), City of Fort Wayne's Exceptions to the I&M Proposed Order ("FWE"), City of South Bend's Exceptions to the I&M Proposed Order ("SBE"), I&M Industrial Group's Exceptions to the I&M Proposed Order ("IGE"), Inovateus Solar LLC's Exceptions to the I&M Proposed Order ("InovateusE"), the Kroger Company's Proposed Order ("KrogerPO") and Exceptions to the I&M Proposed Order ("KrogerE"); and Steel Dynamics, Inc.'s Post-Hearing Initial Brief in Support of Exceptions ("SDIB") and Exceptions to the I&M Proposed Order ("SDIE"). The other parties' filings are voluminous and many of their claims are refuted in I&M's Proposed Order and the record evidence. This Reply does not purport to address each and every error in these filings. Rather, I&M first identifies the fundamental legal and regulatory principles which are ignored or violated by the other parties' proposals and then discusses many of these issues by reference to the relevant findings in I&M's Proposed Order, cited herein as "IMPO."

I. INTRODUCTION

The evidence is undisputed that I&M is not earning a fair return and a rate increase must be granted. After accounting for offsets and decreases in existing rate adjustment mechanisms, the Company's overall proposal results in a net annual increase in revenues of $140,351,382 or 9%. IMPO, at 4. Through substantial evidence and in its Proposed Order, I&M showed this amount is reasonable and necessary to allow I&M an opportunity to maintain and improve its financial health, earn a fair return on the fair value of its property and provide resources enabling I&M to continue to meet the needs of its customers going forward. The record also reflects the Company is a well managed and efficient provider of reliable service. I&M's rates are comparatively low and will remain so if I&M's request is approved.

The other parties ask the Commission to reject I&M's Proposed Order and its evidence. Their filings urge antagonistic, asymmetric action, as if the Commission's duty focuses solely on avoiding rate increases for current customers and punishing utility investors. These filings reflect the view that all matters addressed by I&M and its witnesses are presumed to be disbelieved, ignored or swept aside as insufficient proof. This, the Commission *should not do* and *cannot do.* As the Indiana Supreme Court made clear in 1929:

> We repeatedly hear the expression that it is the duty of the Commission to represent the public alone. If, by this remark, it is meant that the Commission is organized but for one purpose, that of antagonistic action toward utilities under any and all circumstances, then one of the great purposes of the law, adequate service by the utility at the least cost to the consumer, might be entirely defeated. <u>The theory of the law creating the Commission</u>

> is that it shall be conscientiously and impartially administered by a body composed of a personnel especially qualified by knowledge, training and experience pertaining to the subject-matter committed to it for award consonant with reasonable fairness and substantial justice according to legislative mandate, and the circumstances shown relative to its effect in the future on the utility's ability to serve the interest and convenience of the public, the cost and expense to the parties interested being an element for consideration.

In Re Northwestern Indiana Tel. Co., 201 Ind. 667, 674-675, 171 N.E. 65, 67-68 (1929) (emphasis added).

The OUCC repeatedly urges the Commission to disallow I&M costs but fails to justify the exclusion based on probative record evidence or governing law. The Commission may not presume the figures presented by I&M are erroneous. I&M's Proposed Order correctly adheres to the long-standing legal principle that when a given level of revenue, expense or rate base is supported by the testimony of knowledgeable Company officials or duly qualified outside expert witnesses, the Commission cannot disregard the sworn testimony of such witnesses. More importantly, the burden of proof may not be manipulated in such a way as to compel the Commission merely to disregard the Company's sworn testimony and evidence. *See Hancock Rural Tel. Corp. v. Public Serv. Comm'n*, 137 Ind. App. 14, 201 N.E. 2d 573, 587 (1964), *reh'g denied*, 203 N.E. 2d 204 (1964) (the "'evidence was uncontradicted and unimpeached, and the Commission was not at liberty to disregard such evidence and make no special findings upon it.'"); IMPO, at 17.

The appropriate standard to be applied to I&M's expenses is whether they are ordinary and necessary business expenses that are not unreasonable or excessive in amount. Ind. Code § 8-1-2-48. The repeated proposals by the OUCC and other opposing parties that the Commission find it is "not persuaded" or the Company has not met its burden of proof are hollow arguments based on the false premise that the Commission can or should ignore the long-standing presumption of good faith which must attach to the activities of a public utility. IMPO, at 17; *Re Indiana Michigan Power Co.*, Cause No. 39314 (IURC 11/12/93) at 5 ("Good faith is to be presumed on the part of the managers of a public utility like I&M."); *West Ohio Gas v. Public Utilities Com.*, 294 U.S. 63, 72 (1935) ("In the absence of a showing of inefficiency or improvidence, a court will not substitute its judgment for theirs as to the measure of a prudent outlay.") citing *Southwestern Bell Telephone Co. v. Public Service Commission of Missouri,* 262 U.S. 276, 288, 289 (1923) (commission cannot ignore items charged by the utility as operating expense unless there is an abuse of discretion in that regard by the corporate officers."). The sworn testimony of Company officials and expert witnesses is sufficient and substantial evidence, unless and until rebutted by competent evidence, to discharge I&M's obligation to establish a *prima facie* case. Put another way, unless and until rebutted, management good faith in the incurrence of expense must be presumed.

Moreover, many of the OUCC's arguments in this Cause are premised on an attempt to impose a virtually impossible burden of proof standard on I&M – an improper standard that the Commission previously has rejected. In *Re Indiana Michigan Power Co.*, Cause No. 39314 (IURC 11/12/1993) at 6, the Commission, noting it was "troubled" by arguments advanced by the OUCC concerning burden of proof, stated that:

> As discussed more fully hereinafter with reference to each of the specific factual disputes raised, the OUCC has argued for a burden of proof which cannot reasonably be satisfied in the context of a utility ratemaking proceeding.

In reaching its conclusion, the Commission indicated that "in no manner" was it suggesting that the burden of proof on a petitioning utility rose to the standard of requiring "clear and convincing" or "beyond a reasonable doubt" evidence. *Id.* at 5. The Commission re-affirmed this position in *Re NIPSCO,* Cause No. 43526 (IURC 8/25/2010) at 76 ("As we have said before, a petitioner's obligation is to submit "substantial evidence" sufficient for a *prima facie* case, not to satisfy a "clear and convincing" or "beyond a reasonable doubt" standard. Nor may parties ask the Commission to "manipulate the burden of proof in order to merely disallow portions of [a utility's] rate request." (citation omitted)). Calls by the other parties for the Commission to impose an unreasonable burden of proof here must also be rejected.

I&M presented substantial evidence by knowledgeable experts, many of whom the other parties elected not to cross-examine. This evidence rests on a sound factual and analytical foundation. In stark contrast, opposing testimony is replete with statements of concerns, questions, things that "could" be or are "possible"; matters the witnesses raise but concede they do not know or when challenged do not recall; speculation; and language intended merely to cast doubt without the witness knowing one way or the other. *E.g.*¸ Public's Ex. DPJ at 9, WRB at 5, 11, RLK, at 18, 23,30, ERK, at 43,40,67; Tr. T-13, 24, 27, 43, 52, 61, 63, U-92, 112, Y-36,37,49, X-102,103, BB-16-17, 26-28. The objections to I&M's evidence cannot be sustained by vague, unsupported allegations or mere speculative evidence. This is not competent evidence. "[M]ere speculation cannot create questions of fact. Opinions expressing a mere possibility with regard to a hypothetical situation are insufficient to establish a genuine issue of material fact. Put another way, 'guesses, supposition and conjecture are not sufficient to create a genuine issue of material fact.'" *Beatty v. LaFountaine*, 896 N.E.2d 16, 20 (Ind. Ct. App. 2008) (citations omitted), trans. denied 898 N.E.2d 1233 (2008); also *One 1968 Buick v. State of Indiana*, 638 N.E.2d 1313, 1318 (Ind. Ct. App. 1994) (holding that lack of evidence to support assertion made is "purely speculative" and therefore insufficient); *Harper v. James*, 246 Ind. 131, 203 N.E.2d 531, 533 (1965) ("a verdict cannot be based on mere guess, conjecture, surmise, possibility or speculation."). There is vast difference between proof of what is possible and proof of what actually exists. *Daub v. Daub*, 629 N.E.2d 873, 877 (Ind. Ct. App. 1994), trans. denied ("Standing alone, evidence establishing a mere possibility of cause or which lacks reasonable certainty or probability is not sufficient evidence by itself to support a verdict."); *Deery v. Hall*, 175 N.E. 141, 145 (Ind. Ct. App. 1931) ("A mere possibility that a thing may be true will not sustain a legitimate inference that it is true."). "[T]he IURC's discretion lies in the area of assessing the impact of known circumstances." *Citizens Action Coalition v. Public Serv. Co*., 612 N.E.2d 199, 201 (Ind. Ct. App. 1993).

While the Commission may weigh the evidence, refusing to consider competent, uncontradicted evidence and making reasoned findings upon it is not weighing it, it is ignoring it. *Hancock Rural Tel.,* 201 N.E.2d 573 n.1. Adjustments and analysis based upon personal judgment without a consistent rationale are not probative. Additionally, testimony raising concerns, speculation, or questions does not demonstrate that all or part of a particular expense is unnecessary or excessive. Moreover, where questions are raised by other parties, the utility has the opportunity to explain or rehabilitate its position and rebut the evidence submitted by its opposition. The OUCC and Intervenor proposals are not based on the record as a whole and fail to provide detailed findings covering all material basic and ultimate facts. *Ind. Bell Tel. Co. v. Office of Util. Consumer Counselor*, 717 N.E.2d 613, 620, 624 (Ind. Ct. App. 1999), *modified on other grounds on reh'g*, 725 N.E.2d 432 (2000) ("The requirement of detailed findings covering all material basic and ultimate facts is essential, as it enables the court 'to review intelligently the Commission's decision' and thereby ensure that the agency has stayed within its legal authority and jurisdiction.") citing *General Tel. Co. of Ind., Inc. v. Public Serv. Comm'n of Ind.*, 238 Ind. 646, 653, 150 N.E.2d 891, 895 (1958); *Perez v. United States Steel Corp.*, 426 N.E.2d 29, 31-32

(Ind. 1981).

The Commission must reject the invitation to disregard its duty to weigh the totality of the probative evidence. Commission decisions must be supported by specific findings that reveal the Commission's determination of the various relevant sub-issues and factual disputes, which in sum, are dispositive of the claim or ultimate question. *Board of Dirs. for Utils. of Dep't. of Public Utils. v. Office of Util. Consumer Counselor*, 473 N.E.2d 1043, 1047 (Ind. Ct. App. 1985) citing *Perez v. United States Steel Corp.*, 426 N.E.2d 29, 32 (Ind. 1981). Agencies bear the responsibility of making specific findings to protect parties' "legal right to know the evidentiary bases upon which the ultimate finding rests." *Perez*, 426 N.E.2d at 32 (citing Davis, 2 Administrative Law Treatise § 16.05 p. 444 (1958)).

While a rate increase may not be popular, the Commission is obligated to do what is right and just. I&M's capital investment to expand and improve its distribution, transmission and generation facilities that are used to provide service to customers has increased on an Indiana jurisdictional basis by approximately $411 million. IMPO, at 4 citing Chodak Direct, at 16 (Revised). Consequently, the Company's earnings have been and continue to be below the authorized level. Absent timely regulatory relief, the Company's financial position will continue to deteriorate. "When a business disintegrates, there is damage to the stockholders, but damage also to the customers in the cost or quality of service." *West Ohio Gas v. Public Utilities Com*., 294 U.S. 63, 72 (1935).

The record demonstrates I&M continues to work hard to control its operating expenses and to comply with the cost of environmental and other mandates. The record also demonstrates the Company must continue to invest billions of dollars. Prudent regulatory oversight dictates that the Commission take firm steps to alleviate the existing and projected strain on the

Company's financial position. Doing so is fair to consumers, Indiana's local economies and I&M. The record demonstrates that I&M has low rates and if its proposal is approved, I&M will continue to have low rates. Chodak Direct, at 5, 12-13; Chodak Rebuttal, at 8-9. Commission approval of the Company's proposals is reasonable and necessary to ensure that rates are kept as affordable as reasonably possible while continuing to provide adequate financial health so that the Company may be able to protect its credit rating, attract new capital in both the debt and equity markets on reasonable terms, finance system improvements at a reasonable cost, and respond with the flexibility needed to manage unforeseen events. Accordingly, sound regulatory policy, a fair and impartial consideration of the record evidence and adherence to Indiana and constitutional law, lead to the conclusion that I&M's proposed rate relief is just, reasonable and in the public interest.

II. DEPRECIATION RATES

A. Escalation Rate. I&M's Proposed Order demonstrates that the escalation of the demolition cost estimate is reasonable and consistent with Commission precedent. IMPO, at 14. In particular, I&M's Proposed Order explained that the Commission has rejected the OUCC and IG position on this issue at least twice. IMPO, at 14. The OUCC and IG ask the Commission to depart from this precedent without explanation. Indeed, a comparison of the OUCC and IG proposal with I&M's filing shows these parties deleted the citation to this precedent. Ignoring it does not make it go away.

The OUCC and IG offer no valid justification for their proposed finding that evidence is not probative. Nor do they offer any cogent basis or explanation to reject testimony that is consistent with prior Commission determinations. The Commission must apply the law and policy in an even and consistent manner, treating those who are similarly situated in a like manner. *Re Indiana-American Water Co.*, Cause No. 39150 (IURC 6/19/91) at 6, citing *Coppedge v. U.S.*, 369 U.S. 438, 446-47 (1962). Any departure from precedent or change in policy must be fully explained in the Commission's order. *Atchison, Topeka & Santa Fe Ry. Co. v. Wichita Bd. of Trade*, 412 U.S. 800, 808 (1973).

The argument offered to support the OUCC's proposed finding is not compelling. I&M's current depreciation rates are the result of a Commission-approved settlement agreement between I&M and the OUCC. The OUCC contention that there is no "compelling reason to deviate" (OUCCPO, at 15) from this agreement fails to recognize that settled cases are not precedential. Therefore, the OUCC's reliance on the past depreciation settlement agreement is misplaced and its unexplained departure from Commission precedent is arbitrary and capricious. Accordingly, the OUCC's proposed finding regarding escalation of demolition costs must be rejected.

IG's alternative finding should also be rejected. IGE, at 5. The record refutes IG's argument that I&M's inflation rate is stale and Mr. Selecky's factor is more accurate. As Mr. Davis explained, IG's logic for changing the inflation percentage is that the Commission should use more current information than that published in the Livingston Survey dated December 9, 2010. *Id.* at 5. On rebuttal, Mr. Davis showed that the updated Livingston Survey dated December 8, 2011, continues to use the 2.5% inflation factor published in the 2010 survey. In addition, Mr. Davis identified several other current measures of inflation that were higher than 2.5% and therefore support I&M's use of a 2.5% inflation factor as conservative and reasonable. Davis Rebuttal, at 5-6.

Accordingly, the Commission should reject the OUCC and Intervenor exceptions and adopt I&M's proposed finding on this issue.

B. Demolition Conceptual Cost Estimates.

1. Contingency Factor and Non-Depreciable Land. The OUCC takes the position that the contingency factor issue raised by Mr. Selecky is moot due to the OUCC proposal that the Commission accept its argument regarding the Breed Plant actual demolition costs. OUCCPO, at 15-16. As discussed below, this latter argument should be rejected.

IG concedes that: a) the contingency factors should not be removed from the demolition cost estimate; and b) Mr. Selecky's proposal to offer the contingency factors with land value should not be accepted. IGE, at 6. As explained in I&M's Proposed Order, this position is consistent with the evidence and the Commission's order in *Re NIPSCO,* Cause No. 43526 (IURC 8/25/2010). IMPO, at 14. Accordingly, I&M's proposed finding on this issue should be accepted.

2. Revisions Based On Breed Plant Actual Demolition. The OUCC and IG propose the Commission reject the Sargent & Lundy ("S&L") demolition cost estimate for Tanners Creek and Rockport Unit 1. OUCCPO, at 16; IGE, at 6-7. This finding is not supported by probative evidence.

First, the OUCC postulates that it is less costly to demolish Tanners Creek and Rockport Unit 1 using explosives. Notably, there is no cost estimate or site specific study in the record of this case that shows this to be true, much less that any cost difference outweighs the substantial risks. Moreover, the record reflects the S&L demolition cost estimate includes the use of controlled explosives where appropriate. IMPO, at 10; Bertheau Rebuttal, at 8-9. It would be irresponsible to destroy viable and costly infrastructure in an attempt to save a nominal amount of money via use of an uncontrolled demolition technique.

The OUCC and IG ask the Commission to *assume* their "less costly" claim is true because the costs incurred to demolish the Breed Plant are less than the S&L estimated cost to demolish Tanners Creek and Rockport Unit 1. Substantial evidence refutes this assumption. This is an apples to oranges cost comparison because the full scope of the Breed demolition work has not been performed and will need to be completed for any potential future site development. IMPO, at 16. Furthermore, power plants each have unique facility configurations and therefore costs for demolition can vary greatly between facilities. *Id*. at 15. In addition, Breed was a stand-alone unit in a relatively uninhabited area and the dismantlement technique proposed for Breed may not be feasible for the Rockport and Tanners Creek plants which are not similarly situated. *Id*. at 16. Moreover, the permitting, execution and clean-up costs for using uncontrolled demolition at certain sites would be significant and carry significant risk. *Id*. at 15. Finally, the OUCC and IG proposals understate demolition costs in the development of depreciation rates. This approach will make it necessary to recover these costs from customers taking service after the plants have been retired. As the Commission has previously recognized, the better regulatory policy is to recover these costs during the lives of the plants. *Re Indiana Michigan Power Co.*, Cause No. 39314 (IURC 11/12/1993) at 18 ("These [demolition] costs are substantial and should be recovered during the period the plants are in service."); *Re United Telephone Company of Indiana, Inc.*, Cause No. 37762 (PSCI 8/2/85) ("the Commission believes that depreciation rates should be established to enable a utility to recover its investment in an asset over its useful life."). In *Re PSI Energy, Inc.*, Cause No. 42359 (IURC 5/18/2004) at 70, the Commission more extensively discussed this issue, stating that:

> The parties did not disagree that dismantling costs are a part of the cost of current facilities providing current service. They disagreed as to the timing of the collection of such costs and their amount. This Commission can either find that current customers should pay a share of dismantling cost, which will not be incurred for a number of years, or, in the alternative, conclude that these costs

> should be passed onto a future generation of customers. This Commission does not believe that the latter alternative constitutes sound regulatory policy, or is based on sound ratemaking principles. Current customers are receiving service from PSI's generation facilities. A part of the costs of those facilities is dismantlement upon retirement. Therefore, we do not believe it would be appropriate for the Company to backload the dismantlement costs for future ratepayers to pay when the facilities associated with these costs are providing service to current customers. Rather, we find it is appropriate that these costs be shared by all customers that receive service from PSI's generation facilities. Accordingly, the Commission finds that the dismantlement costs are properly included in determining the depreciation rates approved in this cause.

I&M's proposal to use realistic site-specific costs is designed to accomplish the goal of recovering these costs during the lives of the plants. The other parties' proposed finding should be rejected as speculative and otherwise without merit. S&L's demolition cost estimate as presented by Mr. Davis should be accepted.

C. <u>Estimated Service Lives.</u> The OUCC and IG argue the depreciation study should be revised to reflect a slight change in the retirement dates for Tanners Creek Units 1, 2 and 3. OUCCPO, at 8; IGE, at 3. This quarrel overlooks the objective of establishing depreciation expense for ratemaking purposes. The goal is to design rates that depreciate the units over their expected service lives. The OUCC and IG position does not achieve this purpose because the new rates will not be placed into effect until well after the date of the 2010 depreciation study. The fact that this lag is an expected part of the ratemaking process is beside the point. OUCCPO, at 17. This timing difference will more than make up for the slight change in the retirement date for Tanners Creek Units 1, 2 and 3. IMPO, at 11. Accordingly, I&M's proposal is more consistent with the objective to be served by this component of the revenue requirement and should be adopted.

D. Net Salvage Factors. The OUCC proposes the Commission reject Mr. Davis' net salvage factors. OUCCPO, at 19-20. The IG filing incorporates the OUCC proposal. IGE, at 9-10. Tellingly, the OUCC does not argue that Mr. Dunkel is correct. Rather, it asks the Commission find it is not satisfied that I&M has carried its burden of proof. OUCCPO, at 20. The OUCC is wrong.

First, I&M's audited books and records are presumed to be accurate. The questions raised by the OUCC do not demonstrate otherwise. The OUCC claims that annual gross salvage information reported in the FERC Form 1 is different from the total gross salvage reflected in Mr. Davis' study. The amounts identified by Mr. Dunkel are different because they reflect only one piece of the total amount of retirement work in progress ("RWIP"). As signified by the label "RWIP Transferred To In Service," the FERC Form 1 amounts identified by Mr. Dunkel reflect the annual amount transferred from one subaccount to another. The FERC Form 1 does not reflect the entire balance in the subaccount. As a result, merely adding up each year's transfer amount as Mr. Dunkel did, does not establish the total amount of RWIP.

For example, assume there is $100 total in Account A and 100% of the amount in Account A must be removed for purposes of the depreciation study (as both Mr. Dunkel and Mr. Davis agree is the case with regard to RWIP). Also assume that $5 is transferred out of Account A each year for 5 years. This means the annual amount transferred out of Account A is $5 and the total amount transferred for the 5 year period is $25. It also means the Account A balance is $75. Therefore, in order to remove the entire $100, both the remaining balance of $75 plus the $25 in transfers must be removed.

Applying this example to this case, Mr. Dunkel's claim that the total was not removed is flawed because the amount he identified is not the $100 total but rather the $25 in transfers. Put another way, Mr. Dunkel agreed that RWIP should not be included in a depreciation study but his analysis excluded the wrong amount for RWIP. He used the amounts identified as being transferred to in service. In doing so he captured the annual out-going activity in the RWIP account, not the complete balance in the RWIP account. Mr. Davis' explanation of the so-called difference Mr. Dunkel identified is supported by the Company's data request responses, the FERC Form 1 itself, and Mr. Davis' rebuttal testimony (which the other parties elected not to question). Furthermore, a comparison of the FERC Form 1 data to that reflected in Mr. Davis' depreciation study shows that Mr. Davis' recommended increase in depreciation cost to capture the cost of removal net of salvage is reasonable and refutes Mr. Dunkel's speculation that Mr. Davis' analysis may overstate gross salvage. IMPO, at 13, 17-18.

The second argument offered as grounds to reject Mr. Davis' study rests solely on the wording of a label on one of Mr. Davis' spreadsheets. On rebuttal, Mr. Davis swore that his depreciation study included both cash and non-cash salvage. IMPO, at 13, 18. No party questioned this testimony. During cross examination, Mr. Dunkel admitted that Mr. Davis knows the difference between cash and non-cash salvage. IMPO, at 18; Tr. W-96-97. Accordingly, the OUCC suggestion that the Commission reject the sworn testimony of the Company's representative is derisory.

The record evidence more than satisfies I&M's burden of proof. I&M's case-in-chief presented a prima facie case. Once this was done, the OUCC had the burden of going forward with its evidence. The OUCC's evidence amounts to a concern about an accounting issue from a non-accountant who did not actually review I&M's books and records. Mr. Dunkel did not prove that Mr. Davis' analysis was incorrect or unreasonable. Instead, he launched argumentative, yet, unfounded accusations. Mr. Dunkel's concerns were rebutted and I&M

furnished evidence supporting the propriety of the level of net salvage reflected in Mr. Davis' depreciation study. In particular, the record reflects that I&M provided the complete RWIP balance included in the FERC Form 1 salvage and removal amounts in a response to an OUCC data request, but Mr. Dunkel chose to ignore it. Furthermore, the law has long recognized that good faith is to be presumed on the part of the managers of a public utility like I&M. When a given cost is supported by the testimony of knowledgeable Company officials, this Commission cannot simply disregard the sworn testimony. *Re Indiana Michigan Power Company*, Cause No. 39314 (IURC 11/12/1993) at 5. Accordingly, the OUCC and Intervenor exception to I&M's Proposed Order is fatally flawed and should be rejected.

E. Reduction to Retirement Amounts for Tanners Creek Units 1-3 for Common Plant. Because property records for Tanners Creek Plant are not kept by unit, an estimated retirement amount for common plant was calculated for Units 1-3 based on an allocation using megawatt capacity. Davis Rebuttal, at 17. The OUCC proposes this estimate be changed but has not shown the basis of the estimate to be unreasonable or provided adequate information to calculate the actual amount of common plant that should be deducted from the estimated retirement of Units 1-3. Therefore, the OUCC's adjustment is unwarranted and lacks adequate support. As Mr. Davis explained, when Tanners Creek Units 1-3 are retired, the Company will perform a detailed study to determine the proper amount of original cost common plant to retire and any over or under accrual of depreciation will be reflected in future depreciation rates by using the remaining life technique. Davis Rebuttal, at 17. Therefore, the OUCC exception to I&M's Proposed Order should be rejected.

F. Exclusion of Salvage, Cost of Removal and Retirements for Cook Unit 1 Turbine. The OUCC's proposed finding appears to concede that Mr. Davis made an appropriate correction to Mr. Dunkel's calculation. Yet, it urges the Commission to find that "Mr. Dunkel's correction" should be adopted. OUCCPO, at 20. The reference to Dunkel, instead of Davis may be inadvertent error. In any event, the Commission should find that the corrected calculation shown on Petitioner's Exhibit DAD-R3 should be accepted as set forth in I&M's Proposed Order. IMPO, at 19.

G. Terminal Demolition Costs in Interim Net Salvage Factor. The OUCC's and IG's proposed finding wholly ignores Mr. Davis' rebuttal testimony. This testimony was not questioned. Therefore, there is no legitimate reason to ignore it. As Mr. Davis established on rebuttal, Mr. Dunkel's adjustment is incomplete. *See* IMPO, at 12. When the proper adjustment is made, the net salvage percentage equals the percentage calculated in the Company's depreciation study. IMPO, at 19; Petitioner's Exhibit DAD-R5. As a result, it is not necessary to adjust Mr. Davis' depreciation study for this issue.

H. Interim Retirement Revisions Related to Tanners Creek Units 1-3 Retirement. Both I&M and the OUCC (and IG's) filings accept the revised calculation. Because I&M's proposed finding identifies the rebuttal exhibit that reflects the specific revisions, it is more precise and should be adopted instead of the OUCC's proposed finding.

I. Ultimate Finding. I&M's depreciation study is based upon Company specific data and site specific studies of the Company's plant and produces results that are consistent with the Commission precedent. The OUCC and IG's proposals are not based on site specific studies or a review of the Company's books and records. Their criticisms are unfounded and contrary to Commission precedent. These proposals serve no purpose other than to force an under recovery of depreciation expense during the life of I&M's plant in service and an increase in the amount to be recovered after its retirement. Accordingly, the OUCC's and IG's proposed conclusion on the depreciation rate issue should be rejected for the reasons set forth above, in I&M's Proposed Order and I&M's evidence in this Cause.

III. RATE BASE

A. Cook Unit 1 Turbine. With regard to the treatment of the Cook Unit 1 Turbine, the OUCC raises one issue regarding depreciation expense, but otherwise agrees that I&M's proposal regarding the new turbine should be approved. That is to say, the depreciation expense for the Cook Unit 1 turbine shall be reflected in the revenue requirement and I&M shall be authorized to defer the return on this rate base investment from the time the new rates established in this Cause go into effect until I&M's next rate case as proposed by Mr. Krawec.

The OUCC's proposed finding regarding the depreciation expense associated with the Cook Unit 1 Turbine should be rejected. The record reflects the parties agree that the salvage, cost of removal and retirements associated with the Cook Unit 1 turbine replacement should be excluded. IMPO, at 12, 18. In his rebuttal testimony (p. 9-10), Mr. Davis identified a mathematical error in Mr. Dunkel's calculation and presented a corrected calculation on Petitioner's Exhibit DAD-R3 which should be accepted. IMPO, at 12, 18-19. A comparison of Attachment WWD-1, p. 10, Cook Unit 1, Account 323.0 Turbo Generators, columns (a), (d) and (e) to the same information on Petitioner's Exhibit DAD-R3, shows a mathematical mistake. The amount of $158,510,414 multiplied by 1.01 equals $160,095,518 as shown on Petitioner's Exhibit DAD-R3, not $159,873,604 as shown on Mr. Dunkel's attachments.

The OUCC Proposed Order does not address this precise issue. Instead, the OUCC claims that I&M ignored the "necessary puts and takes" and thus the Commission should adopt the OUCC's recommended adjustment. OUCCPO, at 23. Nevertheless, this is a matter of arithmetic, not a game of chance. The 1.72% reference in the OUCC Proposed Order is not a

Cook Unit 1 number. Rather the 1.72% is the total Nuclear Production Plant annual accrual rate (calculated by dividing the total depreciation accrual ($37,125,427 as shown on Petitioner's Exhibit DAD-R3 (col. (X)) by the total original cost plant balance ($2,154,842,670 as shown on Petitioner's Exhibit DAD-R3 (col. (III)). While Mr. Dunkel's calculation also rounds to 1.72%, the arithmetically correct calculation derives from the above referenced rebuttal exhibit.[1] Accordingly, as reflected in I&M's Proposed Order, the Commission should reject the OUCC's proposed finding regarding the Cook Unit 1 Turbine depreciation expense and accept the corrected calculation and resulting annual accrual rate for Nuclear Production Plant reflected on Petitioner's Exhibit DAD-R3.

B. Pension Asset. "Our Public Service Commission Act reflects the traditional notion that the 'fair rate of return' which a regulated utility is permitted to earn must be based upon capital advanced by its investors." *City of Evansville v. Southern Indiana Gas & Electric. Co.,* 339 N.E.2d 562, 585 (Ind. Ct. App. 1975) citing Ind. Code §8-1-2-6. Put another way, when a utility advances funds for the benefit of its customers, the utility is entitled to recover the cost of that investment by including it in rate base. This is the premise underlying the inclusion of fuel supply, materials and supplies, prepayments and other assets in rate base.

The OUCC opposes the inclusion of the pension asset in rate base because it is not utility plant in service. OUCCPO, at 24. This point is irrelevant because rate base is not limited to utility plant as Ms. Stull conceded during cross-examination. Tr. U-89.

The OUCC also presents a vague "foot in the door" argument, the substance of which is that I&M's proposal would somehow expand the definition of rate base "beyond the definition long and well established in Ind. Code §8-1-2-6." OUCCPO, at 31. The OUCC provides no

[1] The product of this calculation is 0.017228834. The product of the same calculation using the numbers reflected on Attachment WWD-1 is slightly different: 0.017223861 because of the mathematical error identified by Mr. Davis.

support for this position and the plain language of the statute and Commission regulation refute it. Ind. Code §8-1-2-6 states that the Commission "shall value all property," not just equipment and other "utility plant." 170 IAC 1-5-9 shows that rate base includes regulatory assets, including those established in accordance with accounting rules as is the case with the prepaid pension reflected on I&M's test year books and records. McCoy Rebuttal, at 4-6; Tr. U-79.

The OUCC also argues the amount of the prepaid pension asset is a matter of "interpretation" due to ERISA rules. OUCCPO, at 31-32. This is a new argument, presented for the first time in the OUCC's post hearing brief. As such, this is mere argument of counsel, not evidence. *See Vanco v. Sportsmax, Inc.*, 448 N.E.2d 1198, 1200 (Ind. Ct. App. 1983) ("A memorandum does not fall within the class of documents to be considered by the trial court under T.R. 56(c). It can only be examined for legal propositions – not facts."); *Conard v. Waugh*, 474 N.E.2d 130, 134 (Ind. Ct. App. 1985) ("[S]tatements of fact set forth in a brief filed in support of or in opposition to a motion for summary judgment may not be relied upon by the trial court (citation omitted)."). Regardless, the contention that the amount of the prepaid asset is subject to interpretation is erroneous. The amount of the asset is governed by accounting standards. McCoy Rebuttal, at 4-6; Tr. U-79. The record reflects no dispute that I&M's books and records properly reflect the amount of the pension asset in accordance with governing accounting standards. Tr. U-57-59; McCoy Rebuttal, at 4-6; IMPO, at 29.

The OUCC also contends that "how a payment should be booked according to FASB does not establish how a payment should be treated for ratemaking purposes." OUCCPO, at 32. It appears this contention was presented to entice the Commission to dismiss Ms. Stull's admission that the pension asset is properly reflected on I&M's books in accordance with the governing accounting standards. Tr. U-79, 105-107. Nonetheless, where, as here, property of the utility is used and useful for the convenience of the public, it is properly reflected in rate base.

The OUCC also argues that the pension asset should be excluded from rate base because I&M's case-in-chief did not provide detailed explanation and the parties have not had sufficient opportunity to fully explore the issue. OUCCPO, at 32. This contention is erroneous. I&M's case-in-chief identified this component of rate base and quantified the amount of the asset as required by the Minimum Standard Filing Requirements ("MSFR"). The pension asset is addressed in the direct testimony of witness Brubaker (pp. 24-25) and reflected on Petitioner's Exhibit A-6, p. 1. The pension asset was also quantified in I&M's workpapers. I&M also provided all other information required by the MSFR, including the utility's pension expense for the test year and an identification of any unfunded amounts and the latest pension actuarial study used to determine the pension accrual. As Ms. Stull conceded during cross-examination, the pension actuarial study explained that contributions to the plan during the prior year reduced the pension cost and improved the funded position. Tr. U-80-83

The existence of the pension asset is not a surprise. It was the subject of testimony in I&M's previous rate case (Cause No. 43306), which was settled and approved by Commission Order dated March 4, 2009. The procedural schedule in this Cause provided the OUCC 155 days to prepare its own case. During this period, the pension asset was subject of discovery and I&M discussed the pension asset with the OUCC and parties during the technical briefing in December 2011. During cross-examination, Ms. Stull admitted that there were no OUCC data requests about the pension asset that I&M did not answer. Tr. U-83-88.

The OUCC contention that I&M's uncontroverted evidence should be ignored because it was presented on rebuttal should also be rejected. OUCCPO, at 33. As just discussed, the

OUCC contention is not true. More importantly, the Commission's determinations are based on the record as whole. As a result, the OUCC point is irrelevant.

Although the other filings may cloud the issue, this matter is not complex. The pension asset issue in this case concerns an actual cash investment made by the utility. The amount of the pension asset is governed by accounting standards and is readily identified on the Company's books and records. The cost of this cash investment, *i.e.,* the time value of money, will not be captured in the ratemaking process used to address pension cost. Materials and supplies, fuel inventory and other assets are reflected in rate base to compensate the utility for the opportunity cost (*i.e.* time value of money cost) incurred to make such investments for the benefit of its customers. Substantial record evidence demonstrates that the pension investment made by I&M has and will continue to lower costs and provide other benefits. *See* IMPO, at 25 - 29. Accordingly, the pension asset is and will continue to be used and useful for the convenience of the public. Therefore, this used and useful property is appropriately reflected in I&M's rate base.

The other arguments offered by the OUCC and Intervenors do not change this conclusion. For example, the OUCC argues that denying I&M the ability to recover its cost of money on the pension asset will not impair the utility's ability to manage its pension costs. OUCCPO, at 32. The OUCC is wrong. Acceptance of the OUCC position means that the utility will not recover the cost incurred to devote its cash to reducing long term pension costs instead of using the funds for other purposes. If such costs cannot be recovered for ratemaking purposes, then prudent utility management will not make such investments and will instead put the utility's cash to other uses. This is precisely why material and supplies, fuel inventory and other assets are included in rate base. Such investment comes at a cost. When such cost is reasonable and beneficial, as is the case here, sound regulatory policy and the governing regulatory framework dictate that the proposed rate base treatment is just and reasonable.

The OUCC and SDI also argue that the pension asset should be excluded from rate base because I&M has an underfunded position or net liability under FAS 158. OUCCPO, at 24-25; SDIE, at 34-35. This is a red herring. The record establishes that this contention confuses apples with oranges. As Mr. McCoy explained (rebuttal, at 20), the Company has a prepaid pension asset because its cumulative *cash contributions* to the pension trust have significantly exceeded its cumulative *pension cost* determined under FAS 87 (which is used for ratemaking purposes). I&M requests the Commission to include the pension asset in rate base in order to recognize the cost of funds on the additional pension contributions. This treatment is reasonable because the advance cash investment has reduced long term costs and benefits customers. The "net liability" determined under FAS 158 is irrelevant to the issue here because I&M seeks to recover the time value of money on a *cash* investment, not on a market value investment. McCoy Rebuttal, at 20-21.

FAS 158 marks-to-market the pension plans funded position through an annual non-cash adjustment to the balance sheet only. *Id*. at 20. FAS 158 does not affect the income statement or the accrued pension cost to be recognized for ratemaking purposes. McCoy Rebuttal, at 20-21. The situation here is not the same as that addressed by the Commission in *Re NIPSCO*, Cause No. 43526 (IURC 8/25/2010). McCoy Rebuttal, at 22. I&M's request is based on actual cash contributions that have substantially benefited customers by reducing the pension cost included in the revenue requirement. The NIPSCO decision concerned a non-cash FAS 158 mark-to-market balance sheet only adjustment. Mr. McCoy's expert testimony on these matters was not questioned. Moreover, these matters are also established by the Commission's order in the NIPSCO proceeding (at 8-9). Accordingly, the OUCC's attempt to dismiss this uncontested evidence through use of the word "allegedly" in its proposed order (OUCCPO, at 30) is wrong as a matter of fact and should be rejected as a matter of law.

I&M's Proposed Order (at 30), explained that the situation presented here is the mirror image of the Commission's decision in *Re Joint Petition of Indiana Bell*, Cause No. 39348, 1992 Ind. PUC LEXIS 409 (IURC 12/30/1992) at 36-37. I&M explained that the consistent application of the rationale stated in Cause No. 39348 means that under the circumstances presented here, the customer should "pay" for the use of the utility's funds at the utility's authorized cost of capital. IMPO, at 30. The OUCC's proposed order does not mention this case by name. Instead, the OUCC makes a fairness argument. The OUCC suggests that fair application of the rationale established in Cause No. 39348 would require a rate base reduction should the cumulative contributions to the pension trust ever be less than the FAS 87 pension cost. OUCCPO, at 33. SDI makes a similar argument. SDIE, at 36. Mr. McCoy recognizes this would be fair. McCoy Rebuttal, at 16. The flaw in the OUCC and SDI analysis arises not from the fairness "theory" but from the application of that theory. The OUCC and Intervenor contend that because rate base reductions have not occurred in the past, the rationale established in Cause No. 39348 should not be applied here. These arguments should be rejected because the positions of the OUCC and SDI rest on the false premise that I&M's cumulative pension cost determined on an accrual basis has *in the past* been less than the pension contributions determined on a cash basis. Notably, the record establishes that the factual predicate to the OUCC argument does not exist. As explained by Mr. McCoy, accounting standards require that the cumulative difference between FAS 87 accrued pension cost and cash pension contributions be recorded on the balance sheet as a prepaid pension asset when cash contributions are greater, or as an accrued pension liability when FAS 87 cost is greater. McCoy Rebuttal, at 16. I&M's books and records reflect a prepaid pension asset, as required by FAS 87, not an accrued pension liability. Because the FAS 87 prepaid pension asset already keeps track of the cumulative difference between pension cash contributions and pension cost, long periods of no pension contribution are already properly accounted for. *Id.* In other words, the pension asset exists in accordance with governing accounting standards; it is not "legal fiction" as the OUCC contends. OUCCPO, at 33.

The OUCC and SDI contend the foregoing facts should be ignored because I&M did not make contributions to the pension trust from 1993 to 2002. OUCCPO, at 33; SDIE, at 35. Notably, neither party explains how historical contributions change the fact that the cash pension asset properly exists on I&M's books. McCoy Rebuttal, at 15-16. Nor do they attempt to reconcile their argument with governing Indiana law. "Absent a specific mandate from the Commission or specific term of a settlement agreement, a utility is not required to maintain expenditures at test year levels." *Re Complaint of IBEW*, Cause No. 43385 (IURC 5/13/2009) at 7.

Moreover, this objection is circular. The evidence shows that FAS 87 requirements keep track of the cumulative difference between pension cash contributions and pension accrued cost. As a result, long periods of no pension contribution are already properly accounted for. If a pension liability existed, the Company's books would reflect a liability, not a pension asset. McCoy Rebuttal, at 14-15. Furthermore, the record establishes that if the Company had made pension contributions during the period 1993 through 2002 as OUCC suggests, *ceteris paribus*, the prepaid pension asset would be that much larger. McCoy Rebuttal, at 15-16; also <u>Petitioner's Exhibit HEM-R1</u>.

SDI argues that the pension asset should be excluded from rate base because AEP board minutes suggest that the contribution might be made using commercial paper. SDIE, at 35.

While the AEP board minutes may accurately reflect what other AEP operating companies did, the unimpeached sworn testimony of Ms. Hawkins and Mr. McCoy establishes that the I&M's contributions were made from I&M's cash. Hawkins Rebuttal, at 6; Tr. DD-82, 88; McCoy Rebuttal, at 3, 6.

SDI's contention about a lead-lag study does not justify the exclusion of the pension asset from rate base. While lead lag studies may be useful in determining "cash working capital", the pension asset is not cash working capital. Furthermore, a lead-lag study is not required to determine the amount of the pension asset because the amount is already perfectly measured under FAS 87. McCoy Rebuttal, at 26-27.

IG argues that because the pension asset was created using ratepayer supplied capital (accumulated deferred federal income tax ("ADFIT") on bonus depreciation), the inclusion of the pension asset in rate base would result in double recovery and also violate the principles established in *City of Evansville v. Southern Indiana Gas & Electric. Co.,* 339 N.E.2d 562, 584-87 (Ind. Ct. App. 1975). IGE, at 12. IG is not correct. The ADFIT created as a result of bonus depreciation (*i.e.,* cost-free capital) was available on new assets. The depreciation expense associated with these new assets was not previously reflected in I&M's revenue requirement in a general rate case. As a result, there is no double recovery because any cost-free capital stemming from depreciation expense did not reflect the cost of the new assets eligible for bonus depreciation. In addition, any ADFIT resulting from bonus depreciation from assets placed in-service as of March 31, 2011 was already included in the capital structure at zero cost in this rate proceeding.

For regulatory and ratemaking purposes, utilities depreciate equipment over its estimated useful life using straight line depreciation. For tax purposes, however, a utility can claim higher depreciation expense in the early years of the service life of an asset and lower depreciation in later years, through accelerated depreciation and investment tax credits. The bonus depreciation reflected in The American Recovery and Reinvestment Act of 2009 was a form of accelerated depreciation. The use of accelerated depreciation for tax purposes results in lower tax payments with respect to the early years of an assets life but then it is offset by increased tax payments in later years. In other words, this is a timing difference. Tax expense not paid during the early years is due in later years. The amount of income taxes deferred through the use of accelerated depreciation is recorded for accounting purposes as accumulated deferred taxes.

For ratemaking purposes, deferred income taxes, including those stemming from the use of bonus depreciation are reflected in the capital structure at zero cost. Petitioner's Exhibit A-7. This means the company does not earn a return on this asset and this treatment is consistent with the *City of Evansville* decision. This treatment of "customer supplied capital" fully addresses the timing difference associated with the treatment of depreciation expense for tax purposes and the treatment of depreciation expense for ratemaking purposes. It does not matter that the cash flows made available were re-invested in rate base assets because the accumulated amount of the deferred taxes is included in the capital structure at zero cost. *See Re Indiana Gas Co., Inc.*, Cause No. 38302, 93 P.U.R.4th 80, 82 (IURC 4/27/88) ("The revenue paid by the customers for service belongs to the [utility]. The amount, if any, remaining after paying taxes and operating expenses including the expense of depreciation is the company's compensation for use of its property.").[2]

In sum, although the OUCC and Intervenors attempt to obfuscate the issue, the matter is neither complex nor novel. All utility property, including cash advancements, which are used

[2] *See also*, this Reply Brief, at 73-74.

and useful for the convenience of the public, is properly included in a utility's rate base for ratemaking purposes. As Ms. Stull agreed, "by allowing the utility to earn the return on the money it has advanced for items in rate base, the utility is properly incented to make good business decisions." Tr. U-96. Here, the record shows that I&M advanced cash and that advancement reduced pension costs, including the pension costs reflected in this case. This means the cash investment is used and useful for the convenience of the public. Accordingly, the pension asset is properly included in I&M's rate base. Therefore, the OUCC and Intervenors opposition should be rejected.

C. Materials & Supplies ("M&S"). The M&S amounts (Total Company) reflected in the record are as follows:

Average for 13 month period ended March 31, 2011	$178,075,379.
M&S inventory balance at end of test year March 31, 2011	$185,556,239.
Average for 13 month period ended December 31, 2011 (rate base cut off date)	$180,987,920

Brubaker Rebuttal, at 4-5; Petitioner's Exhibit JLB-R3. I&M's proposed revenue requirement uses the test year end balance for M&S. This amount is presumed to be reasonable and acceptable for ratemaking purposes until proven otherwise by the party seeking to change this amount (the OUCC). The OUCC agues that the lowest inventory level should be adopted for ratemaking purposes but has failed to demonstrate, as it is required to do, that the test year end balance is not representative of the utility's operations.

The OUCC's adjustment is not based on consideration of I&M ongoing inventory needs or operations and does not show that the test year level is unrepresentative. Rather, the OUCC adjustment points to an amount that is simply lower than the test year and the rate base cut-off date alternatives. This is not sufficient to establish that the test year end balance is unrepresentative, particularly given the substantial evidence presented by Mr. Brubaker showing that the OUCC's amount is unreasonably low. This evidence cannot be simply dismissed as "suspect" as urged by the OUCC. OUCCPO, at 37. The OUCC's citation of 170 IAC 1-5-12(4) does not change this conclusion. This rule set identifies the data to be provided by the utility and I&M complied with it. Accordingly, the OUCC's arbitrary average for M&S should be rejected. The appropriate M&S balance to include in rate base is the actual balance as of March 31, 2011, as adjusted to eliminate amounts applicable to non-utility operations.

D. <u>Original Cost Rate Base.</u> For the reasons discussed above and set forth in I&M's Proposed Order and the record of this Cause, the Commission should adopt the original cost rate base as set forth in I&M's Proposed Order.

E. <u>Fair Value Rate Base.</u> The position of the parties on the fair value of I&M's used and useful property and how that fair value rate base should be used by the Commission in establishing rates in this Cause are quite different. I&M recommends a reasonable and balanced approach to determining a fair value rate base. I&M's proposal is supported by substantial record evidence demonstrating that the Current Cost of I&M's property substantially exceeds its net original cost. Through its evidence and Proposed Order, I&M explained that its fair value approach is not an "either/or proposal"; responds to the Commission's directive that a methodology for determining fair return on fair value should be presented; and is conservative when viewed in light of the inflation adjustment methodology used by the Commission to assess fair value and Commission precedent holding that the current value of utility plant more closely approximates its fair value. IMPO, at 20, 41. It is I&M's position that its fair value rate base must be used in establishing rates in this proceeding and actual effect to the appreciation in I&M's property must be given in setting a reasonable return.

In contrast, other parties urge the Commission to make no meaningful finding on fair value. These alternative proposals provide no insight into how the conclusion regarding the fair value rate base is derived. Of course, the end product of the opposition calculations make clear that the opposing parties seek the Commission to derive a fair value rate base which yields net operating income that is virtually the same as the net operating income the OUCC's and Intervenors' original cost calculations support. The opposing proposals lack evidentiary support, contravene governing law and are without adequate explanation to support a finding by the Commission or to withstand judicial review.

More specifically, the OUCC identifies "two troubling inconsistencies" that it contends "undermine our confidence" in Petitioner's proposed fair value rate base calculation and justify the total rejection of I&M's fair value evidence. OUCCPO, at 45. The first so-called "troublesome inconsistency" rests on Mr. Green's use of a market value approach to determine the depreciated current cost of the production plant and Mr. Moody's use of trended original cost to determine the current depreciated cost of the non-production plant. This difference is neither troubling nor inconsistent. The record reflects that Mr. Green used the market value approach because there is an active market for power plants. IMPO, at 33. In fact, the OUCC proposed order points out that the existence of the wholesale merchant plant market increases the value of generating plants. OUCCPO, at 45-46. Mr. Moody used the trended original cost for the non-production plant because there is not an active market for such plant. IMPO, at 33. The Commission has previously recognized that reproduction cost new less depreciation is the best indicator of the property's current value in the absence of an active market. *Indiana Michigan Power Company*, Cause No. 39314 (IURC 11/12/1993) at 57. The use of a market value approach for the power plants is consistent with established appraisal methodologies and not inconsistent with Mr. Moody's use of trended original cost for the non-production plant.

The OUCC asserts that the use of the market value approach "was to I&M's benefit" but it fails to identify any record evidence that supports this speculation. OUCCPO, at 46. Mr. Moody showed that the fair value presented by I&M is lower than the fair value that results from the inflation methodology used by the Commission to assess fair value of utility plant. Moody Rebuttal, at 6-7. This refutes the OUCC's conjecture that the approach presented by I&M was selected because it was "to I&M's benefit."

The OUCC's second "troublesome inconsistency" concerns the Company's proposal to change its depreciation accounting rates. OUCCPO, at 46. In utility ratemaking, depreciation expense is designed to recognize the cost of the plant, including cost of removing the plant net of salvage, over the life of the plant. The OUCC urges the Commission to reject the market value of the generating plants because Mr. Green's Discounted Cash Flow ("DCF") analysis did not reflect demolition costs in his appraisal. This point stems from Mr. Kaufman's speculation, not from credible analysis. Mr. Kaufman conceded that he was not an appraiser and did not conduct an analysis to determine what, if any, impact demolition costs would have on the current value of the generating plants. Tr. AA-20. The OUCC elected not to question Mr. Green or Mr. Moody.

The absence of quantified demolition costs from Mr. Green's analysis does not establish that such costs should have been included in the market valuation of the generating plants, much less, that its inclusion in the market valuation of the power plants would result in a total plant value that is less than the weighted fair value presented by I&M here. As Mr. Moody explained, the market value study was based on the actions of participants in the market for generating plants. In that market, plants are not typically demolished. The site and much of the infrastructure is redeveloped as another, new plant site which has significant value. This value offsets any cost of removal of the portion of the plant not used by the purchaser. Moody Rebuttal, at 9. Furthermore, because demolition costs would be incurred in the distant future, such costs would be a low present value in the DCF analysis. Accordingly, the record refutes the OUCC speculation that the "fair value" of the generating plants presented by I&M is too high because the "current value" piece of the "fair value" did not include adjustment for demolition costs.[3]

The OUCC's remaining arguments do not justify the rejection of I&M's current value evidence, much less the rejection of I&M's proposed fair value. First, the OUCC concedes that fair value ratemaking rule sends appropriate signals to utility management, citing to the decision in *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308, (1989). Therein, the Supreme Court also stated that its practical difficulties with fair value ratemaking have led "to its abandonment as a [federal] constitutional requirement." *Id.;* OUCCPO, at 47. This latter point is erroneous as a matter of Indiana law. Indiana has maintained its fair value ratemaking requirement and the Commission has repeatedly rejected arguments from the OUCC and Intervenors that it should be ignored. *See* IMPO, at 21 - 22.

Second, I&M's uncontroverted rebuttal evidence demonstrated that the criticisms offered by the OUCC and Intervenors lacked merit and even if accepted they have little impact on the current value of the Company's assets and even less impact on the Company's proposed fair value (3.4%). Moody Rebuttal, at 4-5; see IMPO, at 37.

Third, the technological obsolescence argument the OUCC presents rests on Mr. Kaufman's testimony. Mr. Kaufman expressed a concern regarding Mr. Moody's use of trended

[3] While I&M's evidence is consistent, the OUCC's position is not. It is disingenuous for the OUCC to argue for purposes of determining the current value of the generating plants that increased demolition costs should be considered while at the same time arguing that the Sargent & Lundy estimate of demolition costs for the generating plants is too high.

original cost to determine the depreciated current value of I&M's non-production plant. This concern was made based on testimony offered by other witnesses in water utility rate cases. Neither Mr. Kaufman nor any other OUCC or Intervenor witness showed that technological obsolescence exists much less identified its exact nature relevant to the facilities studied by Mr. Moody. On the other hand, Mr. Moody's unimpeached sworn testimony shows that an adjustment for technological obsolescence is misplaced in the context of the electric utility facilities he valued, *e.g.* poles, towers, conductors, services, conduit and line transformers. Mr. Moody's unimpeached sworn testimony establishes that although there has been incremental technological improvement in some types of substation equipment over the years, these improvements have not lead to either lower cost or shorter lives for existing equipment. Moody Rebuttal, at 2.

Finally, the opposing parties' proposed conclusions on fair value must be rejected because the "totality of the evidence" refutes them. OUCCPO, at 47; IGE, at 16-18. Substantial uncontested evidence, including the valuation based on the Commission's own inflation methodology, demonstrates that the net current value of I&M's utility plant and I&M's proposed fair value of its utility plant remains significantly in excess of its net original cost even if the unfounded criticisms of the valuation are taken into account. Moody Rebuttal, at 4-5; Green Rebuttal, at 3-7. The other parties elected not to question Mr. Green or Mr. Moody. As a consequence, the most the record reflects relevant to the value of I&M's plant at March 31, 2011 is that the value might be slightly less than its Current Cost.

While the Commission has authority to weigh the evidence regarding original cost and Current Cost, the Commission's decision must be based on substantial record evidence and supported by basic and ultimate findings of fact. The Commission's decision must comport with

Commission precedent or justify the departure from precedent. The other parties' proposals regarding fair value meet none of these requirements. Based on the totality of the evidence Commission cannot find that the fair value of I&M's plant is only "slightly above" its net original cost (OUCCPO, at 47) or that "material flaws" in I&M's studies were identified by OUCC and IG witnesses. IGE, at 14.

IG characterizes I&M's fair value method as a repugnant "separate but equal" approach. IGE, at 15. It appears IG desires the Commission to penalize I&M because it specifically identified how its conservative fair value was derived (*i.e.* by weighting net original cost and net Current Cost based on the debt/equity ratio in I&M's capital structure) and because the authorized net operating income I&M seeks is less than that produced by other fair value ratemaking methodologies. I&M's presentation of a specific rationale responds to the Commission's directive in its order in Cause No. 39314 (at 87), that rate requests should be supported by a methodology for determining a fair return on the fair value of utility plant and the Commission's more recent findings that fair value will not be considered as an academic matter. *Re NIPSCO*, Cause No. 43526 (8/25/2010) at 14 ("The Commission does not engage in such decision-making for academic pursuits, and we do not do so here."). While I&M presented a specific proposal and supported that proposal with substantial evidence demonstrating that it is just, reasonable and economically sound, I&M recognizes that the Commission is the ultimate decision-maker. However, the weight to be given to net original cost and Current Cost evidence must be determined in the light of the facts of the case. Here, the record reflects that the current value of the Company's utility plant greatly exceeds its net original cost. Due to inflation and other factors, net original cost does not constitute a real indication of the plant's current value. It is well established that the "Commission may not ignore the commonly known and recognized fact of inflation." *Indianapolis Water Co. v. Public Service Comm'n*, 484 N.E.2d 635, 640 (Ind. Ct. App. 1985).

The Commission has previously stated "[w]e believe that the fair value of a utility's property is most analogous to the true current worth of the property, perhaps what a willing buyer would pay a willing seller in an arm's length transaction." *Re Indiana Cities*, Cause No. 39166 (IURC 7/8/1992) at 37; *Re Indiana Michigan Power Co*., Cause No. 39314 (IURC 11/12/1993) at 46. The Commission has also found that in the absence of an active market for the sale of utility plant and equipment, reproduction cost new less depreciation is the best indicator of the property's current value. *Re Indiana Michigan Power Company*, Cause No. 39314 (IURC 11/12/1993) at 57. The Commission has found that despite the criticisms of the methodology, reproduction cost new analysis "is unquestionably more reflective of fair value . . . than is original cost." *Id.* at 59. Moreover, while the Commission has previously afforded great weight to current cost in determining fair value, Petitioner's proposal here is much more conservative. Because I&M's proposed fair value of its utility plant reflects <u>both</u> net original cost and net Current Cost, it obviates the need for the Commission to weigh the shortcomings of the reproduction cost methodology.

Both this Commission and other commissions have used specific methodologies to determine a fair value rate base, including the methodology I&M proposes here. *Re Indiana-American Water Co.*, Cause No. 39595, 150 PUR4th 141, 165-65 (IURC 02/02/1994) (weighting original cost and reproduction cost new less depreciation based on non-common equity to common equity ratio); *Re Arizona Pub. Serv. Co.*, 258 PUR4th 353, 371 (Ariz. Corp. Comm'n 06/28/07) ("The Commission has traditionally determined the 'fair value' rate base by taking the average of the [original cost rate base] and [reproduction cost new rate base]."); *Re Southwestern*

Pub. Serv. Co., 27 PUR4th 302, 307 (N.M. PSC 12/05/1978) (weighting reproduction cost new based on common equity portion of capital structure); *Pennsylvania Pub. Util. Comm'n v. T.W. Phillips Gas and Oil Co.*, 26 PUR4th 1, 5 (P.A. PUC 07/06/1978) (weighting original cost and trended original cost components of fair value rate base by percentage of debt and equity, respectively); *Re El Paso Electric Co.*, 23 PUR4th 131, 139 (N.M. PUC 12/15/1977) (applying 60/40 weighting of original cost to reproduction cost new based on capital structure). In *Re PSI Energy, Inc.,* Cause No. 40003 (IURC 9/27/1996) at 18, the Commission created its own inflation methodology to establish a fair value rate base. ("We reach this determination by escalating the fair value of Petitioner's used and useful property at July 31, 1993, found in Petitioner's last rate case to be.…"). The Commission has used this methodology in many cases since. *See Re Indiana-American Water Co.,* Cause No. 44022 (IURC 6/6/2012) at 10 (updating fair value finding from 2010 Rate Order for inflation that has occurred since last valuation date.); *Re Indiana-American Water Co.*, Cause No. 42520 (IURC 11/18/2004) at 45 (adjusting the prior fair value for inflation); *Re PSI Energy, Inc*., Cause No. 42359 (IURC 5/18/2004) at 6-7, (adjusting the fair value found in last rate case for inflation.); *Re Indiana-American Water Co*., Cause No. 40703 (IURC 12/11/1997) at 28-29 (adjusting prior determination for inflation.). The application of the Commission's inflation methodology shows the fair value of I&M's used and useful plant in service as of March 31, 2011 exceeds $4 billion. This amount exceeds the fair value amount for I&M's plant of $3,468,970,000 that I&M proposes the Commission use for ratemaking purposes in this Cause. Moody Rebuttal, at 8; IMPO, at 40.

In sum, I&M's proposed fair value amount is reasonable and conservative because it produces a result that is less than the result produced by the Commission's methodology and a result that is less than its Current Cost notwithstanding Commission precedent establishing that

Current Cost is unquestionably more reflective of fair value than is net original cost. Accordingly, the Commission should reject the arbitrary conclusions offered by the opposing parties and find instead that the fair value of I&M's plant in service is no more than $4,047,570,890 and accept I&M's proposal that the fair value of its used and useful plant for purposes of fixing rates in this Cause should be $3,468,969,555 as set forth in I&M's Proposed Order.

IV. <u>FAIR RATE OF RETURN AND NET OPERATING INCOME</u>

A. <u>Overview.</u> While the other parties' spread token acknowledgement in their filings of what the law actually requires in terms of a fair return on the fair value of I&M's used and useful property, they ignore both the legal principles set forth and the factual evidence in this case in their proposed findings. Ultimately, they recommend a confiscatory return for I&M. These proposals give no actual effect to the current fair value of I&M's used and useful property and rely upon the subterfuge of calculating a required return on fair value that essentially equates to weighted average cost of capital multiplied by the net original cost rate base. This approach, regardless of the rhetoric packed around it, has repeatedly been declared unlawful in the State of Indiana. *Gary-Hobart Water Corp. v. IURC*, 591 N.E.2d 649 (Ind. Ct. App. 1992) *reh'g denied* and *trans. denied*; *Indianapolis Water Co. v. Public Service Comm'n.*, 484 N.E.2d 635 (Ind. Ct. App. 1985); *Columbus Gaslight Co. v. Public Service Commission*, 193 Ind. 399, 140 N.E. 538, 539 (1923).

Substantial record evidence establishes that the current fair value of I&M's property substantially exceeds its net original cost. This appreciation in value cannot be undercut by merely reducing the fair rate of return. Doing so prevents I&M from receiving the benefit of the increase or appreciation in its property and contravenes authority such as *Columbus Gas Light v.*

Public Service Commission, 193 Ind. 399, 140 N.E. 538 (1923). The opposing parties ignore this and other substantial record evidence, including the rate of return provided to comparable electric utilities in other jurisdictions. Incredibly, the OUCC and Intervenor proposals are substantially below returns the Commission has recently approved for other lower risk utilities. Simply put, the other parties' return proposals fail even the simplest red face test. These proposals also fail each and every test for constitutional sufficiency set forth by the U.S. Supreme Court – failing to provide a sufficient return to attract net capital, to fairly compensate existing investors for the risk associated with their investment commensurate with other investments of similar risk, and failing to produce an *end result* which is nonconfiscatory. This result is not permissible in any jurisdiction, let alone this one. It ignores substantial record evidence and violates both the letter – and the spirit – of the Indiana law on fair value ratemaking. In sum, I&M is entitled under Indiana law to a fair and reasonable return on the current fair value of its used and useful property. The opposing parties' proposed orders render fair value ratemaking a meaningless exercise, are not the product of rational decision making based on thoughtful and probative evidence, and produce an unlawful and confiscatory result. Therefore, these proposals cannot be accepted by the Commission.

The discussion below further highlights the fundamentally flawed nature of the opposing party proposals but is not intended to be a comprehensive discussion of all errors in these filings. These matters are already refuted in the record evidence and I&M's Proposed Order. I&M's failure to address an issue raised by an opposing party is not intended to and does not reflect I&M's agreement.

B. Comparable Risk Electric Proxy Group. The electric proxy group is used to analyze cost of equity for electric utilities with *comparable risk*. An appropriate group reflects companies of comparable risk based on objective indicators. The purpose of proxy selection is to identify the largest possible group of comparable risk companies that has sufficient data to apply reliably cost of equity methodologies, such as the DCF, Capital Asset Pricing Model ("CAPM") and risk premium. Both Mr. Kaufman and Mr. Gorman started with Dr. Avera's proxy group. Neither witness offered any meaningful criticisms of Dr. Avera's electric utility proxy group. Mr. Gorman excluded three companies due to recent merger and acquisition activities and was left with an electric proxy group that had stronger credit ratings and better Standard and Poor's ("S&P") business risk profile than I&M. Gorman Direct, at 12-13. This means Mr. Gorman's proxy group has lower risk relative to I&M; in fact only three of Mr. Gorman's proxy companies were ranked as weaker than I&M. Avera Rebuttal, at 11. Similarly, of the 18 utilities in Mr. Kaufman's proxy group, all but four were ranked stronger than I&M. *Ergo*, both Mr. Kaufman and Mr. Gorman used an electric proxy group that has *lower* risk than I&M. Dr. Avera's direct testimony explained the fundamental risk exposures that drive investors to regard I&M as a relatively risky utility, including its exposure to nuclear power and large capital needs. Avera Direct, at 7-20; Avera Rebuttal, at 11. The end result is that I&M must offer investors a higher return than its peers to compete for capital. The OUCC and Intervenor's return recommendations fail to consider the fundamental factors driving risk.

The four key indicators of risk are S&P Credit Rating, and Value Line Safety Rank, Financial Strength, and Beta.[4] Mr. Kaufman did not modify Dr. Avera's electric utility proxy group based on risk indicators. Instead, he made selective changes based on a given electric company's operations and ended up with the smallest electric utility proxy group presented in

[4] Bond yields, for example, reflect investors' expected rates of return and bond ratings measure the risk of individual bond issues. The observed yields on government securities and bonds of various rating categories demonstrate that the risk-return tradeoff exists. Avera Direct, at 22.

this case.[5] Yet, company operations are not a factor that drives investor views of risk. Investors use the parameters identified above to assess risk. OUCC urges the Commission to find that requiring utility proxy group members to have similar revenue percentages "is reasonable" (OUCCPO, at 80), but OUCC fails to explain why consideration of this factor is appropriate. The record refutes it. *E.g.* Tr. 110-111. Because the observable credit rating, safety rank, financial strength and Beta already reflect such matters, the OUCC's proposed finding reflects a selective downward bias because it makes a downward adjustment for a matter already reflected in the analysis. Additionally, by limiting the size of the proxy group, the OUCC incorporates another downward bias into the analysis to achieve a desired result. Such manipulation of the data is contrary to the purpose of the exercise, which is to use the largest possible group of comparable risk companies so as to provide the most robust sample that minimizes observation errors.

In sum, the OUCC's electric proxy group is "not sufficiently large" or better than the others presented. Rather, the OUCC's electric proxy group is the smallest presented in this case and was developed by relying on non-risk factors. The salient criterion in establishing a meaningful benchmark to evaluate a fair ROE is relative risk, not the particular business activity or degree of regulation. Furthermore, like IG's proxy group, the OUCC's proxy group has lower risk than I&M. Accordingly, the OUCC proposal (OUCCPO, at 80) that the Commission find Mr. Kaufman's proxy group is better should be rejected. Thoughtful consideration of the other parties' ROE analysis should reflect the fact that the OUCC and IG recommendations are too low because their analysis was performed using lower risk proxy groups.

[5] Mr. Kaufman eliminated 4 companies based on their percentage of regulated electric revenues operations; one company due to its status as a transmission company; and another company with an equity ratio lower than Petitioner's. Kaufman Direct, at 10-11. Mr. Kaufman did not eliminate these companies based on use of trackers as the OUCC proposed order suggests.

C. **<u>Non-Utility Proxy Group.</u>** The cost of capital is an opportunity cost based on the returns that investors could realize by putting their money in other alternatives. Undoubtedly, the total capital invested in utility stocks is only the tip of the iceberg of total common stock investment. There are a plethora of other enterprises available to investors beyond those in the utility industry. Utilities must compete for capital, not just against firms in their own industry, but with other investment opportunities of comparable risk. *See* Avera Direct, at 26.

OUCC and IG propose the Commission fix Petitioner's cost of equity without resorting to a non-utility proxy group. OUCCPO, at 81; IGE, at 28. These parties recognize that the Commission should not dismiss the non-utility proxy companies simply because they are "not utilities", but they essentially ask the Commission to go ahead and do so anyway. The Commission should reject these proposals.

First, the contention that the comparable risk proxy group must "mimic Petitioner's operations" is not correct. OUCCPO, at 81; IGE, at 28. The Supreme Court has recognized that it is the degree of risk, not the nature of the business, which is relevant in evaluating an allowed ROE for a utility. Avera Direct, at 27, quoting *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679, 692 (1923) ("*Bluefield*"). In other words, the inherent differences between regulated utilities and non-utility companies do not justify disregarding the non-utility proxy group because the record shows the non-utility group is comparable based on degree of risk. The fact that this group is not regulated is precisely why this analysis provides useful insight, where as here, the companies have comparable risk. The analysis shows the return which would be commensurate with returns on other investments of corresponding risk.

Second, Dr. Avera's non-utility proxy group is comprised of 53 of the best-known and most stable corporations in America. Avera Direct, at 31. The comparable risk non-utility proxy group was selected using the same risk measures as Dr. Avera used for the utility proxy group. The OUCC and IGE suggest the Commission ignore the non-utility proxy group based on concerns about screening criteria, *i.e.,* comparability. This criticism fails to recognize that both Mr. Kaufman and Mr. Gorman, by starting with Dr. Avera's proxy group, accepted Dr. Avera's screening criteria. The risk criteria applied by Dr. Avera (S&P Credit Rating, and Value Line Safety Rank, Financial Strength, and Beta) are the risks that investors see and consider when making investor choices. If these criteria are acceptable for identifying comparable risk utility companies they should also be acceptable for identifying comparable non-utility companies. Furthermore, all companies in the comparable risk non-utility group pay a dividend. Avera Direct, at 28. The record establishes that the criteria used by Dr. Avera consider a broad spectrum of risks, including financial and business position, relative size, exposure to company specific factors and any risk-reducing benefit of regulation (including the trackers). The average corporate credit rating for Dr. Avera's Non-Utility Proxy Group is <u>higher than the average for the Utility Proxy Group and I&M</u>. Avera Rebuttal, at 83. The fact that the indicators are comparable is objective evidence that investors perceive the non-utility companies to be a comparable, albeit somewhat lower risk investment than I&M. Avera Direct, at 30-31.

Third, the opposing parties contend this economic analysis should be dismissed because the economic models show that the cost of equity for the non-utility proxy group is higher than the cost of equity for the utility counterparts. OUCCPO, at 81; IGE, at 28. This obviates the purpose of the exercise. In other words, because the risk characteristics for the utility and non-utility proxy companies are comparable, it is illogical and circular to conclude that the difference in the results indicates that the companies have substantially dissimilar risk characteristics. The non-utility proxy group analysis is conducted as a check on the regulatory electric utility proxy group results. If the results for the non-utility companies are higher than the results for the comparable risk utilities, this indicates that the comparable risk regulated utility group results are too low. Accordingly, because the risk parameters for the two groups are the same, the results for the non-regulated group should not be tossed aside simply because the results are higher. To do so would be contrary to sound research methodology. Therefore, the Commission should find that the estimate of the required return for firms in the competitive sector is useful in determining the appropriate return for I&M and reject the OUCC's and IG's contention otherwise.

D. Discounted Cash Flow ("DCF") Analysis. In order to apply the DCF model correctly, one must attempt to estimate investors' consensus about what the growth rate will be. The record reflects that as predictors of future returns, security analysts' growth estimates have been shown to be more accurate than growth rates derived from historical data. *See* IMPO, at 74. The most reliable way to estimate the growth rate investors are actually using when they purchase a particular stock at a particular time is to reference publications used by investors and research on investor behavior as Dr. Avera did in his analysis. *See* IMPO, at 67. Mr. Gorman's testimony corroborates this view. *Id.* The reasons offered by the OUCC as grounds to give less weight to Dr. Avera's DCF analysis should be rejected.

First, the OUCC suggests that a Commission order in a past water and sewer utility rate case provides a sufficient basis to discredit Dr. Avera's analysis. Notably, I&M is not a water or sewer utility. The findings made by the Commission in *Re Utility Center*, Cause No. 43874 (IURC 4/13/2011) based on another expert's analysis and different record do not provide a credible basis to discredit Dr. Avera's DCF analysis in this case. The record here establishes that

Dr. Avera exercised sound judgment and used objective inputs. Thus, his testimony is consistent with Commission precedent, not contrary to it as suggested by the OUCC.

Furthermore, concerns about growth rates in the water and sewer industries are not relevant here because this case involves an electric utility and the purpose of the exercise is to estimate *future* expectations of investors relevant to the electric industry. In this case, substantial evidence of record demonstrates that past trends in earnings, dividends and book value are not representative of investor's expectations for the future due to structural and industry changes. These structural and industry changes have led to declining growth in electric utility dividends, earnings pressure and, in many cases, significant write-offs. Avera Direct, at 34-37; Avera Rebuttal, at 64-66. In fact, both Mr. Gorman and Dr. Avera agreed that earnings per share growth forecasts represent a superior guide to investor expectations. Avera Rebuttal, at 64. As Mr. Gorman himself concluded (at 19), "[a]nalysts' growth rate forecasts generally are the best reflection of investors' outlook, and three-to-five year analysts' growth rate forecasts are reasonable estimates of long-term sustainable growth."

Second, the OUCC contends Dr. Avera's DCF analysis should be discredited because an abstract from a 2008 article cited by Mr. Kaufman states that market analysts working for investment bank and brokerage firms have conflicts of interest. OUCCPO, at 82. The OUCC urges the Commission to find the many articles that establish the opposite view are "unpersuasive." OUCCPO, at 82. The OUCC's summary acceptance of a quotation from an abstract is as illogical as its proposed summary rejection of literature establishing the contrary view. It also defies common sense and current market conditions. Dr. Avera refuted Mr. Kaufman's contention that analyst forecasts are optimistic, with his expert opinion. Avera Rebuttal, at 31. Dr. Avera supported that opinion with a quotation from Roger Morin's text titled *New Regulatory Finance*. *Id.* He stated that there are other studies that contradict Mr. Kaufman's position that analysts' projections are optimistic. *Id.* Dr. Avera identified and discussed these studies on page 34 of this rebuttal. He quoted from two articles on pages 33-34 in support of his view that comparisons between forecasts of future growth expectations and the historical trend in actual earnings are largely irrelevant in evaluating the use of analysts' projections in the DCF model. Notably, the textbook, studies and articles are not in the evidentiary record and Dr. Avera's discussion of these matters was not questioned. Hence, there is no evidentiary basis for the Commission to state that it reviewed theses materials or otherwise dismiss them as proposed in the OUCCPO, at 82.

The OUCC's proposal that the Commission rely on the articles cited by Mr. Kaufman ignores substantial evidence demonstrating that his select references do not provide a complete picture of the financial research in this area; many studies and articles show the opposite; and the sources Mr. Kaufman relied on tend to pre-date the 2003 final judgment that results in changes in analyst compensation and reporting. Avera Rebuttal, at 34-35. The OUCC position also ignores uncontroverted record evidence establishing that the key issue is regardless of their accuracy, investors rely on analyst projections. Avera Rebuttal, at 31-32.

The record reflects that investors' pay for financial analysts' forecasts. Investors would not do this if they did not consider the forecasts to add value to the investors' decision making. Furthermore, Dr. Avera's analysis did not rely exclusively on analyst forecasts. He also presented an analysis based on Value Line projected dividends and earnings per share. Avera Rebuttal, at 40. Value Line is a well-recognized source in the investment and regulatory communities that does not sell or underwrite securities. In its proposed order, the OUCC ignores the well-known fact that Value Line is not engaged in investment banking or other relationships with the companies it follows. Yet, this fact reinforces Value Line's impartiality in the minds of investors. The OUCC's own exhibit (Schedule ERK-2 page 3 of 4) shows that the average Value Line forecasted earnings per share growth is 6.17% versus 4.87% for the Yahoo.com and Zacks that survey analysts in the capital markets produced. This means that the consensus analyst estimates are actually lower than those published by Value Line, which is immune to any potential conflicts associated with investment banking operations. This thwarts the OUCC's unsupported allegations of bias and its summary dismissal of the probative evidence in this case.[6]

Third, I&M's Proposed Order identified problems with the two-stage DCF model. IMPO, at 69. Among other things, I&M explained that FERC abandoned this model and instead uses the constant growth model using earnings per share projections and sustainable growth, just as Dr. Avera did in his analysis. *See* IMPO, at 69; Avera Rebuttal, at 37-39. In its proposed order and without explanation, the OUCC suggests that Mr. Kaufman's two-stage DCF model and his inputs are grounds to give less weight to Dr. Avera's DCF analysis. OUCCPO, at 64-65, 81-82. It does not. Mr. Kaufman presented no evidence that investors evaluate the future based on the assumptions and data required for a two-stage model. Furthermore, Mr. Kaufman's testimony contradicts the OUCC proposal. He opined that more weight should be given the single stage DCF analysis, which uses Value Line data. Kaufman, at 19. When added together, the inputs Mr. Kaufman used in his two-stage model (the Value Line growth rate of 6.17% and dividend yield of 4.25%) equal 10.42%. This supports Dr. Avera's DCF analysis; it does not discredit it.

Finally, the notion that Dr. Avera's growth rate is "irrationally high" rests on truncated data and the illogical view companies cannot grow faster than the overall economy during the

[6] See also, this Reply Brief, footnote 10.

horizon relevant to investors. IGE, at 28; Avera Rebuttal, at 69-70. The OUCC's suggestion that the Commission can rely on pension returns as supportive of the OUCC's recommended ROE (OUCCPO, at 83) ignores substantial unquestioned testimony of Dr. Avera establishing three key reasons why pension return assumptions are not comparable to the ROE used in utility ratemaking. Avera Rebuttal, at 54-55. Accordingly, the Commission should reject the opposing parties' position that Dr. Avera's analysis should be ignored.

E. Capital Asset Pricing Model ("CAPM"). The OUCC and IG also urge the Commission to ignore Dr. Avera's CAPM analysis. OUCC asks the Commission instead to give substantial weight to the OUCC's analysis because the OUCC result is consistent with a Commission position adopted at least twenty years ago, and because Mr. Kaufman believes a 9.0% estimated market return is more reasonable. IG argues that Dr. Avera's market rate of return is highly inflated. IGE, at 28. These reasons do not warrant the rejection of Dr. Avera's analysis.

The OUCC fails to point out that the methodology used by Dr. Avera obviates the need to engage in the arithmetic versus geometric mean debate. Tr. D-112; Avera Rebuttal, at 45-48. As a result, it is illogical to reject Dr. Avera's analysis based on a Commission decision about a different approach. Furthermore, the economic evidence relied on by the Commission twenty years ago to develop its position on this issue has changed over time. OUCCPO, at 82-83; IMPO, at 80. "The prospect of a Commission repeatedly approving any type of adjustment conjures up images of a Commission so frozen by time worn custom that inappropriate adjustments are accepted, without regard to the specific facts presented, because of a blind allegiance to the past." *Re Indiana Bell*, Cause No. 37200-S1, 37200-S2 (PSCI 2/3/1984), at 7 citing *Re Indiana Gas Co., Inc.,* Cause No. 36816, 49 PUR 4th 594, 599 (PSCI 10/27/1982).

The 9.0% estimated market return is obviously absurd. It falls far below: a) the 10.0% return expected for Mr. Kaufman's own electric proxy group; b) the 10.2% average expected return for Mr. Gorman's electric proxy group; and c) the 9.70% ROE found to be fair and reasonable for Indiana American Water Company, which without question is significantly less risky than I&M is as an electric utility with a nuclear power plant (*Re Indiana American Water Company*, Cause No. 44022 (IURC 6/6/2012) at 43; *see* IMPO, at 81); and d) the 10.1% return the Commission authorized for a lower risk gas utility in *Re Indiana Utilities Corporation,* Cause No. 44062 (IURC 9/5/2012).

The remaining criticisms identified in the OUCC proposed order were also refuted by Dr. Avera and discussed in I&M's Proposed Order. The OUCC's filing ignores all of this and urges the Commission to do likewise simply because the OUCC does not like the results. The Commission should reject this invitation to ignore this thoughtful and probative analysis. The various economic models are used to inform the Commission, not to confirm a pre-determined outcome. Moreover, Dr. Avera's analysis is based on objective data and in contrast to Mr. Kaufman's analysis does not adjust such data based on personal opinion, vague preferences or other subjective factors.

IG's analysis also ignores the substantial evidence Dr. Avera presented regarding the fallacies of Mr. Gorman's arguments. Avera Rebuttal, at 73. This evidence shows that the use of forward-looking expectations in estimating the market risk premium is well accepted in the financial literature. IG's criticism seems to hinge on the fact that this method produces an equity risk premium for the S&P 500 that is considerably higher than the historical benchmarks Mr. Gorman cites. But estimating investors' required rate of return by reference to current, forward-looking data, as Dr. Avera has done, is entirely consistent with the theory underlying the CAPM methodology. The CAPM is an *ex-ante*, or forward-looking model based on expectations of the future. As a result, in order to produce a meaningful estimate of required rates of return, the CAPM is best applied using data that reflects the expectations of actual investors in the market. Rather than look backwards to a risk premium based largely on historical data, as IG advocates, Dr. Avera's analysis appropriately focused on the expectations of actual investors in today's capital markets.

Notably, IG does not suggest that the CAPM model is "wrong" to focus on forward-looking projections. Rather, IG urges the Commission to disregard Dr. Avera's analysis because applying the CAPM in a manner that is consistent with the underlying model assumptions produces a result that IG views as being too high. However, the application of alternative methods of economic analysis is not a process of deviating from the underlying assumptions of the model until the results are consistent with those produced using an alternative approach. As the IURC has recognized, the whole point is to obtain independent observations that can be weighed in determining a fair ROE. *Re Southern Indiana Gas and Electric Co*., Cause No. 43839 (4/27/2011). Therefore, because the opposing parties' analysis used subjective adjustments contort the results of their economic models, the Commission should give their analysis less weight and reject their proposals to dismiss Dr. Avera's economic test results.

F. <u>Size Adjustment.</u> The OUCC cites Mr. Kaufman's testimony and the Commission's Order in *Re Indiana American Water*, Cause No. 43680 (IURC 4/30/2010) at 47 as grounds to dismiss Dr. Avera's size adjustment. OUCCPO, at 84. The OUCC also contends the articles cited by Mr. Kaufman support his view that it is unnecessary to increase Petitioner's cost of equity to account for "a small company risk adjustment." OUCCPO, at 66. Notably, the OUCC's proposed order, particularly the words "small company risk adjustment," does not accurately represent Dr. Avera's adjustment, which was made due to an observed inability of the CAPM model to fully reflect the impact of size distinctions by market capitalization that the beta value does not otherwise captured, but which is acknowledged by empirical research. Avera Rebuttal, at 49. In his rebuttal testimony, Dr. Avera established that his adjustment is not the same as either the type of adjustment criticized by Mr. Kaufman or the type of adjustment addressed by the Commission in Cause No. 43680. Simply put, the record demonstrates that the theory offered by the OUCC does not hold up. IMPO, at 72. Dr. Avera's consideration of the impact of firm size does not adjust for I&M's size relative to the proxy group; nor is it applied to the results of the DCF, risk premium, or expected earnings approaches. Rather, it is specifically tied to the CAPM because empirical research indicates that the beta coefficient does not capture differences in investors' required rates of return that are related to firm size. To account for this, Morningstar has developed size premiums that need to be added to the theoretical CAPM cost of equity estimates to account for the level of a firm's market capitalization in determining the CAPM cost of equity. Avera Rebuttal, at 49, 51. Dr. Avera's rebuttal testimony was supported by financial literature and was not questioned. Moreover, the record clearly establishes that I&M clearly is not a private water utility, its position within the industry is not one of very low risk, and the Company's history demonstrates that it does not have anything near a guarantee of earning a fair ROE. Avera Rebuttal, at 50; *see* IMPO at 72. Therefore, the OUCC's proposed discussion of the size adjustment should be rejected because it is contrary to substantial unimpeached record evidence and unsupported by the precedent identified in the OUCC filing.

G. <u>Risk Premium and Expected Earnings Models.</u> The OUCC discussion of Dr. Avera's risk premium and expected earnings analysis boils down to a criticism of these economic models. These models offer a straightforward opportunity cost test. This test does not require theoretical models to indirectly infer investors' perceptions from stock prices or other market data. As long as the proxy companies are similar in risk (which is the case here), their expected earned returns on invested capital provide a direct benchmark for investors' opportunity costs that is independent of fluctuating stock prices, market-to-book ratios, debates over DCF growth rates, or the limitations inherent in any theoretical model of investor behavior.

The expected earnings approach provides a direct guide to ensure the allowed ROE is similar to what other utilities of comparable risk will earn on invested capital. Here, the record shows that the expected returns for both Mr. Kaufman's and Mr. Gorman's electric utility proxy group greatly exceed the return recommended by the OUCC and IG. If I&M is only allowed the opportunity to earn a 9.2% or 9.5% on the book value of its equity investment, as recommended by the OUCC and IG, while other electric utilities are expected to earn an average of 10.5% or more, the implications are clear – I&M's investors will be denied the ability to earn their opportunity cost.

These models have been accepted by this Commission and other commissions. Avera Rebuttal, at 13-17. Dr. Avera demonstrated that the NARUC's compilation of regulatory policy identified the comparable earnings approach as a favored method in 24 of the agencies surveyed. Avera Rebuttal, at 15. These models should not be ignored here simply because these results do not support the ROEs recommended by the OUCC and IG. The whole point of using different economic models is to obtain independent observations that can be weighed in determining a fair ROE. This purpose cannot be achieved if data is dismissed or manipulated to be consistent with pre-determined outcome. In *Re Indiana-American Water Company,* Cause No. 40703 (IURC 12/11/1997) at 43, the Commission observed that all methodologies for estimating the cost of capital have their unique advantages and limitations. After discussing some limitations of the comparable earnings approach, the Commission concluded that the comparable earnings analyses "can be used for purposes of assisting the Commission in establishing a range of values to consider, and testing the reasonableness of the fair return finding." *Id*. at 43. This is exactly what Dr. Avera proposes in this case. Dr. Avera distinguished his comparable earnings methodology from that presented in past cases and demonstrated that his analysis is not subject to the same criticism. Avera Rebuttal, at 12. For example, his analysis does not rely on historical data taken from the accounting records but instead uses on projections of returns on book investment published by Value Line, a recognized investment advisory publication. Because these returns on book value equity are analogous to the allowed return on a utility's rate base, this measure of opportunity costs results in a direct, "apples to apples" comparison. Dr. Avera showed that Mr. Kaufman has previously used an analogous approach. Avera Rebuttal, at 13. Thus, the Commission should embrace this analysis as a useful tool and reject the proposal that the Commission give no weight or find no benefit to this evidence.

H. Flotation Costs. The common equity used to finance the investment in utility assets is provided from either the sale of stock in the capital markets or from retained earnings not paid out as dividends. Avera Direct, at 59. Common equity capital is not free. When equity is raised through the sale of common stock, there are costs associated with "floating" the new equity securities.

In this Cause, there is no dispute that flotation costs must necessarily be incurred when a utility issues securities. Likewise, there is no serious dispute that I&M has incurred flotation costs. These costs were documented and reported in Dr. Avera's direct testimony (at 60). Both the parties and the Commission had substantial opportunity to investigate and verify these costs. Additionally, there is no dispute that apart from a flotation adjustment in the determination of the authorized return, there is no other established mechanism for these costs to be recognized for ratemaking purposes.

While debt flotation costs are recorded on the books of the utility, amortized over the life of the issue, and thus increase the effective cost of debt capital, there is no similar accounting treatment to ensure that equity flotation costs are recorded and ultimately recognized. In contrast, no rate of return is authorized on flotation costs necessarily incurred to obtain a portion of the equity capital used to finance plant. In other words, equity flotation costs are not included in a utility's rate base because that portion of the gross proceeds from the sale of common stock used to pay flotation costs is not available to invest in plant and equipment. Nor are flotation costs capitalized as an intangible asset. Therefore, unless some provision is made to recognize these issuance costs, a utility's revenue requirements will not fully reflect all of the costs incurred for the use of investors' funds. Because there is no accounting convention to accumulate the flotation costs associated with equity issues, these costs must be accounted for indirectly, with an upward adjustment to the cost of equity being the most logical mechanism. Avera Direct, at 59-60.

The OUCC opposes ratemaking recognition of flotation costs in this case because the OUCC contends the timing of the securities issuance is not right. OUCCPO, at 67, 85. This objection is invalid because a) these costs have not previously been recognized for ratemaking purpose; and b) it has nothing to do with the fact that the costs are not excessive and were and continue to be necessarily incurred to provide electric service.

IG argues that ratemaking recognition of flotation costs is inappropriate if the utility is a subsidiary whose equity capital is obtained from its parent, such is the case with I&M. IGE, at 28. This argument ignores the fact that the parent-subsidiary relationship does not eliminate the costs of a new issue – it merely transfers them to the parent. Fair treatment must consider that if the utility-subsidiary had gone to the capital markets directly, flotation costs would have been incurred by that utility. Furthermore, because a stand-alone issuance may cost more, the exclusion of flotation costs on this basis is contrary to the goal of providing service economically.

Under Indiana law, reasonable and necessary costs of providing service are properly reflected in the ratemaking process. Ind. Code § 8-1-2-48. The OUCC's reliance on the Commission's 1996 decision in *Re PSI Energy, Inc.*, Cause No. 40003 (IURC 9/27/1996) is misplaced. This 1996 decision indicates that the flotation costs at issue were issued decades prior to the test year. *Id.* at 30. This is not the case here. Avera Direct, at 60; Tr. D-116-117. In the 1996 PSI decision, the Commission indicated it was likely that the issuance costs had been excluded for ratemaking purposes due to the significant periods of time elapsing between rate cases. The record here shows that these necessary costs have not and will not be recognized for ratemaking purposes even though the Commission's last I&M rate order was issued just over three years ago. Moreover, the 1996 PSI decision reflects that the Commission expected market-based rates to replace traditional ratemaking. This once anticipated change in the regulatory framework has not occurred. Consequently, this past decision regarding another utility does not support the rejection of the flotation cost adjustment here. To the contrary, substantial record evidence establishes that in order to recognize these costs for ratemaking purposes it is necessary to make a flotation cost adjustment in the determination of the authorized return. The OUCC's and IG's conclusion otherwise prevents these costs from being recognized for ratemaking purposes and if accepted will further undermine I&M's ability to earn its authorized ROE. *See* IMPO, at 82. Moreover, other Commission determinations support the view that flotation cost adjustment is allowed when it is based on verifiable costs available for examination. *See Re Indiana-American Water Company*, Cause No. 43680 (IURC 4/30/2010) at 47-48. As noted above, Dr. Avera identified and quantified this cost adjustment in his direct testimony and the OUCC, Intervenors and Commission had ample time to examine the reasonableness of these costs. Accordingly, the opposition to the flotation adjustment should be rejected.

I. <u>Impact of Off System Sale ("OSS") Margin Rate Adjustment Mechanism.</u> OSS margins are volatile based on the interaction of market forces in the electricity market. If a substantial sum, such as $33 million (Blakley) or $37.5 million (Dauphinais) is embedded in I&M's basic retail rates, it would be a significant portion of I&M's authorized net operating income and an amount far in excess of that embedded in other Indiana electric utility revenue requirements. Brady (Adopted Busby) Rebuttal, at 11-13. If market conditions turn out so that OSS margins fall far below the amount embedded in basic rates, I&M will suffer a significant earnings shortfall. Given the Company's relatively weak bond rating and history of significant under-earnings, inclusion of such a significant offset to retail revenue requirements could damage I&M's credit ratings and financial integrity, contrary to the "end result test." Avera Rebuttal, at 87-88.

OUCC urges the Commission to find that "We do not believe" this. OUCCPO, at 86. What is not to believe? These are undisputed facts and conclusions arrived at via simple arithmetic. The two reasons offered by the OUCC for the proposed 'disbelief' lack merit. The OUCC concedes that the level of wholesale market derived OSS margins the OUCC seeks to embed in the retail revenue requirement is "substantial and highly volatile." OUCCPO, at 207. Furthermore, although it argues otherwise, the OUCC Proposed Order does not treat the OSS margins "separate from the calculation of net operating income" OUCCPO, at 86. Rather, the

OUCC proposes the Commission find that "all OSS net income shall be included as jurisdictional income for purposes of the FAC earnings test." OUCCPO, at 208; *see also* IMPO, at 179. Therefore, the OUCC's proposed finding regarding the impact of the OUCC's OSS margin sharing mechanism on I&M's financial integrity should be rejected.

J. <u>I&M's Credit Rating.</u> OUCC urges the Commission to find that "we are convinced that I&M is strongly positioned in its current credit rating [which is only two notches above junk bond status]" because the company has maintained this credit rating since 1995 and Mr. Lorton opined that a credit rating "is not imminent." OUCCPO, at 86. The Indiana Supreme Court decision in *Public Service Comm. v. Indiana Bell Telephone Co.*, 235 Ind. 1, 130 N.E.2d 467, 481 (1955) establishes that a rate level which is sufficient merely to keep the company's capital intact (cost of capital at original cost) and cover expense or merely produce some return over that amount is not equivalent to a *fair* return.

In addition, Mr. Lorton's testimony was based on I&M's historical financial performance ending on February 29, 2012 and does not consider the natural or obvious consequence of other known developments that lead to the conclusion that I&M's metrics will deteriorate if I&M is not able to recover its cost of providing service and earn a fair return. In particular, the record reflects that I&M's bond rating is weak relative to its peers in the electric utility industry and going forward I&M will incur increased investment and expenses. Avera Rebuttal, at 7; IMPO at 62. I&M's kilowatt hour sales are forecasted to decline or remain relatively flat. Chodak Rebuttal, at 3; *see also*, Tr. CC-102-103.

Importantly, the OUCC's proposal fails to consider potential adverse consequences of the Commission being wrong on this issue.[7] The record reflects SWEPCO, a sister company about

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[7] A simple example illustrates this oversight. At the beginning of a football game a coin toss decides which team receives the football. There is a 50% probability that the coin will land on "heads" and a 50% probability that the

the same size as I&M, had a higher credit rating than I&M and engaged in a construction program smaller than I&M's program. SWEPCO was downgraded from Baa1 to Baa3 all at once because of the strain that construction costs placed on SWEPCO's balance sheet. Tr. CC-96. The record here shows I&M's credit metrics are already weak, particularly for a utility that has a nuclear power plant associated with it. The record reflects that if I&M were to get downgraded to junk status, its interest rates would go up 100 to 200 basis points. *Id.;* Tr. CC-97. On a $1 billion investment or $1 billion in debt over 20 or 30 years, that's hundreds of millions of dollars of additional costs that would not otherwise be reflected in customer rates had the credit rating been maintained. What's more, once a downgrade occurs, a lengthy period of superior financial performance is required to try to reverse it. This is not a question of improving I&M's credit rating, but one of maintaining it so that costs are kept low.[8] Therefore, the Commission should reject the OUCC's proposed finding on this issue.

K. <u>Cost of Capital Conclusion.</u> The foregoing discussion illustrates many, but not all of the flaws, reflected in the OUCC and Intervenor post-hearing briefs and proposed orders, and shows that the 9.2% and 9.5% ROE recommended by the OUCC and Intervenors should be rejected. The following simple analysis further demonstrates that the OUCC and Intervenor recommendations are facially unjust. On June 6, 2012, the Commission found a 9.70% ROE is fair and reasonable for Indiana American Water Company, an investor-owned *water* utility. *Re Indiana-American Water Company*, Cause No. 44022 (IURC 6/6/2012) at 36. The water utility, its risk and circumstances are vastly different from those presented in the instant case. I&M, the

coin will land on "tails." Likewise, if a revolver has six cartridges but only three chambers have bullets and the other three are empty, there is still a 50% probability that a bullet will be fired on the first pull of the trigger and a 50% probability that it will not. Yet, the importance of the coin toss result turning out as predicted pales by comparison to the importance of the revolver firing as expected.

[8] *See also* Tr. CC-98 (explaining that Indiana's provision of a return on construction work in progress helps from a cash flow perspectives but has no impact on earnings or the debt issue and thus does not solve this problem) and Tr. CC-109-110 (explaining importance of looking holistically at the issue).

OUCC and IG all recognize that I&M has relatively greater investment risk than other utilities. Avera Rebuttal, at 10-11. I&M's exposure to nuclear power issues, its large capital needs and other fundamental risk exposures drive investors to regard I&M as a relatively risky utility. These differences alone compel the conclusion that the 9.7% ROE awarded in Cause No. 44022 would be woefully inadequate for I&M and approval of the OUCC and Intervenor recommendations would be punitive and harmful to the public interest. The recent Commission decision in *Re Indiana Utilities Corporation,* Cause No. 44062 (IURC 9/5/2012), further illustrates the confiscatory nature of the OUCC and Intervenor recommendations. This case concerned a gas utility that has two ratemaking adjustment mechanisms in place to protect its income. *Id.* at 22. The Commission found that a 10.10% COE is appropriate for that gas utility. Unlike the gas utility in Cause No. 44062, I&M owns a nuclear plant and other large power plants, its financial metrics are and continued to be strained by large capital investments and other expenditures needed to comply with environmental and other regulatory mandates and otherwise maintain safe, reliable and economic electric service. I&M has no rate decoupling mechanisms to protect its income.

The expected returns for both Mr. Kaufman's and Mr. Gorman's electric utility proxy groups show that these comparable risk companies are expected to earn at least a 10% ROE. The authorized returns for both Mr. Kaufman and Mr. Gorman's proxy groups also prove to be higher than the ROEs Mr. Kaufman and Mr. Gorman are recommending for I&M in Indiana. *Id.* Furthermore, the Comparable Risk Non-Utility Proxy Group analysis shows an average COE range of 10.3% to 12.3%. This evidence also points to the conclusion that the OUCC and Intervenors proposed conclusion on cost of capital should be rejected.

The Order in Cause No. 44022 considered ROE recommendations ranging from 8.60% to 11.50% with an average of 9.60%. The Commission awarded an ROE that exceeded that average. While the computation of an average provides some insight, such calculations are only as good as their inputs and do not replace the need for consideration of the actual record evidence. The ROE recommendations in the instant case range from 9.2% to 11.15% with an average of approximately 10.2% and an average of 10.57% using the corrected ROE floor as explained in I&M's Proposed Order. IMPO, at 80-81.[9] As also explained in I&M's Proposed Order, when the evidence of record in this case is taken into consideration, including evidence regarding the importance of maintaining I&M's financial integrity, an ROE of 11.15% is just, reasonable and consistent with the *end result* test. IMPO, at 41-56, 61-84.

Competition for capital is intense, and utilities such as I&M must be granted a real opportunity to earn an ROE comparable to contemporaneous returns available to investors from alternative investments if the Company is to maintain its financial flexibility and ability to attract capital. The ROEs recommended by OUCC and IG threaten I&M's financial integrity and if adopted would be "so unjust as to be confiscatory." *See Verizon Communications* v. *FCC, et al.,* 535 U.S. 467, 524 (2002) (quoting *Duquesne,* 488 U.S. at 307, 312 (1989)). Therefore, the OUCC and Intervenor ROE determinations should be rejected and I&M's Proposed Order should

[9] I&M's Proposed Order explains that *assuming arguendo* I&M was expected to actually earn Mr. Kaufman's 9.2% recommended ROE (a point refuted by substantial record evidence), such a return would not produce an *end result* that would enable I&M to compete effectively with other utilities to attract capital because it falls far below the 10.0% return expected for Mr. Kaufman's own proxy group. Furthermore, the record reflects I&M's actual rate of return during the test year was 5.47% despite an authorized rate of return of 10.5%. Considering that each 1% of ROE equates to approximately $17 million in revenue, the revenue increase recommended by the OUCC will not even raise I&M's return on equity to the 9.2% suggested by the OUCC. The record also shows that the expected earnings for Mr. Gorman's proxy group (Petitioner's Exhibit WEA-R2) average 10.2%. Because Mr. Gorman's recommended ROE falls far below what the utilities in Mr. Gorman's own proxy group are expected to earn, it violates the opportunity cost standard underlying a fair ROE and is insufficient to allow I&M an opportunity to attract capital on reasonable terms. *See* Avera Rebuttal, at 17. Given the substantial record evidence, including Mr. Kaufman's own testimony that I&M's risks warrant a higher return, the 10.0% benchmark represents a floor on the range of credible ROE estimates for the Company under current circumstances.

be adopted.

L. Overall Weighted Cost of Capital. I&M's Proposed Order reflects I&M's test year capital structure. The OUCC asks the Commission to accept Mr. Eckert's adjustment because doing so matches the rate base cut off date. Notably, the matching concept and use of current data are concerns wholly ignored in the OUCC's finding on other issues, including materials and supplies and capacity settlement payments/receipts. In this light, the OUCC's proposed finding seems intended to drive a lower result. Nonetheless, the question is whether the OUCC has shown both 1) that the test year capital structure is unrepresentative of future operations; and 2) that the OUCC's adjustment is both representative and in sync with the other elements of the revenue requirement. It has not. Furthermore, the test year capital structure is more indicative of the target capital structure for the period the rate authorized in this case will be in effect. Accordingly, the OUCC's proposed adjustment to the test year operating results should be rejected.

M. Fair Rate of Return.

1. OUCC. The OUCC's case-in-chief presented a revenue requirement based on an original cost calculation, *i.e.,* weighted average cost of capital multiplied by net original cost rate base. In its proposed order, the OUCC "backs into" its original cost based proposal. As such, the OUCC presentation is a superfluous mathematical exercise that lacks both economic and financial logic and evidentiary support.

The OUCC proposed order agrees that a fair rate of return is one which under efficient and economical management will produce a return comparable to return on investments in other enterprises having corresponding risks. OUCCPO, at 95. Yet, as just discussed, the OUCC's and Intervenor's proposed fair returns are substantially less than the return for utilities the other parties concede have comparable risk and preposterous when compared to the ROE recently awarded by the Commission in *Re Indiana American* Water, Cause No. 44022 (6/6/2012) and *Re Indiana Utilities Corporation*, Cause No. 44062 (IURC 9/5/2012). The OUCC also agrees that a fair return must be sufficient to ensure confidence in the financial integrity of the Petitioner and sufficient to maintain and support the Petitioner's credit. Substantial evidence demonstrates that Petitioner must make large capital investments. The fair return proposals offered by the other parties are not sufficient to permit I&M to attract capital as reasonably required in its utility business. OUCC urges the Commission to issue a proposed order based on the premise that as of February 2012 a ratings downgrade is "not imminent." OUCCPO, at 86. The looming doom stemming from these words does not instill investor confidence and it should sound alarms at the Commission that the rate increase proposed by I&M must be authorized.

I&M's rates are the lowest of the investor-owned electric utilities in the state and will remain comparatively low if I&M's proposed rate increase is approved. I&M has not earned its authorized return historically and the record demonstrates that I&M is not likely to actually earn its authorized fair return even if I&M's proposal is approved in its entirety. Clearly, there is no legitimate concern in the instant case about I&M's proposed rates being "so high as" to be "an exorbitant price" that gives "the utility owner an unreasonable or excessive profit." OUCCPO, at 96 quoting *Public Serv. Comm'n of Ind. v. City of Indianapolis*, 131 N.E.2d 308, 318 (Ind. 1956). The pendulum swings the other way. The Commission must balance the utility owner interests and approve I&M's proposed rate increase. Doing so protects the broad public interest. It provides for the continued provision of safe, reliable and economic electric service, compliance with regulatory mandates and Indiana law, and allows I&M to maintain its credit and attract capital on reasonable terms.

I&M has presented a conservative and fair methodology for determining a fair return on the fair value of its utility property under Indiana law and consistent with the *Hope* and *Bluefield* standards. While it is true that I&M's methodology for determining a fair return incorporates an original cost calculation as one component of the fair return determination, the OUCC and Intervenor suggestion that I&M agrees this one component is sufficient is erroneous. This conclusion is refuted by substantial record evidence establishing that Commission adoption of fair return to fair value rate base equivalent to a return under original cost ratemaking will not meet the *Hope end result* test or comply with Indiana law. The combination of past attrition, the prospect of future investment, and the key role of financial strength for I&M in the present and coming years makes the incremental dollars from the fair return important to satisfying the *end result* test. *E.g.,* Avera Rebuttal, at 60; Chodak Direct, at 30-31; Chodak Rebuttal, at 2-3, 6-7; Avera Direct, at 66, 64, 76-77, 79-80; Avera Rebuttal, at 4, 6, 10, 55-63, 75-77; Tr. D-107-109.

The OUCC points out that Professor Bonbright is not a fan of fair value ratemaking. OUCCPO, at 96-97. This is not breaking news. This well known fact is precisely why the Bonbright quotation identified in Dr. Avera's rebuttal testimony (at 60) that favors the use of fair value ratemaking as proposed by I&M in this case is so instructive.

The suggestion that I&M's proposal regarding a fair return is somehow unfair is a strawman argument; it rests on the faulty premise that an original cost calculation is the standard by which I&M's proposal should be judged. That is not the case in Indiana or the real world as Dr. Avera explained. Avera Direct, at 66-67, 79. Moreover, I&M's fair return proposal will establish an authorized net operating income that is less than the authorized or expected return for comparable risk companies. While cost of capital evidence is an important element of the ratemaking process, cost of capital is not synonymous with a fair rate of return. The determination of a fair rate of return must take into consideration all the relevant evidence and be established in such a way as to assure confidence in the financial soundness of the utility, be adequate to maintain and support the utility's credit and enable it to raise the money necessary for the proper discharge of its public duties.

The OUCC criticism of Dr. Avera's reference to the Arizona Commission proceedings is unfounded. He correctly identified the source of the fair value incremental calculation and produced supporting documentation from Arizona. The Arizona Commission found that the methodology would result in a fair rate of return on the fair value rate base, is based upon sound economic and financial theory, and supports the return that it adopted in *Re Chaparral City* Water, Decision No. 70441 (Ariz. CC 7/28/2008) at 34, 37. Nothing was hidden. The OUCC contention otherwise is meritless. OUCCPO, at 97.

The Parcell testimony quoted by the OUCC (at 97) demonstrates that in the circumstances presented here 1) a fair return must exceed the return that would be awarded by simply multiplying the net original cost rate base by the weighted average cost of capital; and 2) this additional return can be justified in policy considerations. In Indiana, ratemaking policy and the financial and economic objectives to be achieved thereby are set by our General Assembly; which has found that fair value ratemaking shall be used.[10]

Under the law of fair value, I&M is entitled to a return on the fair value of its property devoted to public service, not the original cost value embedded in the OUCC and Intervenor

[10] This is the same David C. Parcell who authored the study guide titled "The Cost of Capital; A Practitioner's Guide" for the Certified Rate of Return Analyst ("CRRA") designation which Mr. Kaufman cites as a key element of his professional qualifications. Tr. AA-11-12; Kaufman, at 3. Notably, Mr. Kaufman's positions on fair return are contradicted by the Practitioner's Guide in at least two other respects. First, this Guide teaches that the comparable earnings test method is "easily understood" and firmly anchored in the regulatory tradition of the *Bluefield* and *Hope* cases, as well as sound regulatory economics. Avera Rebuttal, at 15-16. Second, this Guide finds endorses reliance on Value Line forecasts and states that investors place the greatest reliance of such forecasts. Avera Rebuttal, at 35. As discussed above, the Value Line forecasts support Dr. Avera's analysis.

filings. Furthermore, substantial evidence demonstrates that I&M's fair value methodology is consistent with economic and financial principles and designed to achieve sound regulatory objectives. As proposed by I&M, the fair value increment will serve as a tool to offset attrition so that I&M has a realistic opportunity to actually earn its authorized net operating income.

The OUCC's contention (OUCCPO, at 97) that I&M has not presented sufficient evidence on the costs and benefits of the fair return increment proposal is erroneous. We do not need a study to know that customers are harmed if I&M cannot earn its authorized fair return. Furthermore, the record shows that given the importance of the utility industry to the economy and society, it is essential to maintain reliable and economic service to all consumers. The record shows that a utility's ability to fulfill its mandate can be compromised if it lacks the necessary financial wherewithal or is unable to earn a return sufficient to attract capital. The record shows the major rating agencies have warned of exposure to uncertainties associated with ongoing capital expenditure requirements, uncertain economic and financial market conditions, future environmental compliance costs, and the potential for continued energy price volatility. The record shows that I&M faces a number of potential challenges that might require the relatively swift commitment of considerable capital resources in order to maintain the high level of service to which its customers have become accustomed. The record shows that investors understand just how swiftly unforeseen circumstances can lead to deterioration in a utility's financial condition, and stakeholders have discovered first hand how difficult and complex it can be to remedy the situation after the fact. In particular, the record shows that SWEPCO, a similarly sized sister company to I&M, was downgraded two notches as a result of a construction program smaller than the one in which I&M is engaged. The record shows that a downgrade would increase investment costs by hundreds of millions of dollars. Tr. CC-97. The Company's

$17 million fair return proposal pales by comparison.

The scenarios presented in the OUCC's proposed order misrepresent the issues pending before the Commission. I&M is not asking to *improve* its bond rating. Rather, I&M's proposal is designed to *maintain* its current position in the face of attrition and other financial challenges. Put another way, the record shows that I&M has not earned its authorized return and its financial metrics will deteriorate if this continues. The objective of the fair value proposal is to fix this problem. That said, the OUCC's singular focus on bond cost is misplaced because the cost of debt is only one piece of the picture. Credit ratings allow utilities to negotiate with vendors and access capital markets in time of turmoil.

The OUCC's deferred tax cash flow argument is also erroneous. OUCCPO, at 99. The cash flow impact from deferred income taxes is not earnings, but a difference in timing on tax payments. Moreover, the record reflects that the cash flow benefit will reverse during the period the rates fixed in this proceeding will be in effect.[11]

Furthermore, customers benefit when the utility's financial position is supported by the underlying regulatory framework. Providing an opportunity for I&M to earn a fair return that is both commensurate with those available from investments of corresponding risk and sufficient to maintain I&M's ability to attract capital, even under duress, is consistent with the economic requirements embodied in the U.S. Supreme Court's *Bluefield* and *Hope* decisions. It is also in customers' best interests. Ultimately, it is customers and the service area economy that enjoy the benefits that come from ensuring that the utility has the financial wherewithal to take whatever actions are required to ensure a safe and reliable energy supply.

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[11] In this context the logic of the OUCC's argument highlights the absurd nature of its proposal (9.2% ROE less 8.29% = 0.91%).

In sum, the OUCC arguments regarding the fair return ignore or mischaracterize substantial record evidence, contravene Indiana's fair value ratemaking statute and sound regulatory policy, and violate the economic requirements embodied in the U.S. Supreme Court's *Bluefield* and *Hope* decisions. Accordingly, these proposals should be rejected.

2. IG. IG urges the Commission to reject I&M's proposal regarding the fair return on the fair value of its property because it is new. In IG's words, the Commission should enter an order based on original cost and find that "we are confounded" that I&M would ask us to do this any other way.

I&M's request is not confounding; it is responsive to the explicit instructions from the Commission. In Cause No. 39314, the Commission accepted the fair value ratemaking theory but found the utility proposal lacking due to the absence of a specific methodology. *Re Indiana Michigan Power Company*, Cause No. 39314 (IURC 11/12/93) at 60. More recently, the Commission has indicated that fair value must be presented on more than academic terms. *Re NIPSCO*, Cause No. 43526 (8/25/2010) at 14 ("The Commission does not engage in such decision-making for academic pursuits, and we do not do so here."). While IG suggests otherwise, I&M has not argued that the Commission must determine the fair return on fair value using this methodology. IGE, at 16. Rather, the Company's position is that a) Indiana law requires the Commission to authorize a return that gives actual effect to the current fair value of the Company's used and useful property; and b) the methodology I&M presented for determining the fair value of its property and the overall fair return on the fair value of that property produces a just and reasonable result under the circumstances presented here.

The methodology for determining the fair value of I&M's plant in service is straightforward. Weight net original cost and net current cost based on the debt and equity ratio in the capital structure. This method has been used in Indiana elsewhere.[12]

IG argues the Commission is justified in ignoring the Company's evidence regarding the fair value of its plant because the Company's proposed net operating income ("NOI") is derived without regard to this evidence. IGE, at 4. This argument overlooks that I&M's proposed fair value rate base reflects both original cost and current cost. While I&M's methodology calculates the NOI using the original cost component, this is only one part of the two-step methodology proposed by I&M for determining a fair return on the fair value of its used and useful property.[13] The suggestion that the Commission is free to ignore Indiana's fair value statute because I&M presented a multi-step methodology for determining a fair return is erroneous and should be rejected.

V. OPERATING RESULTS

A. AEP Pool Capacity Settlements. The OUCC and Fort Wayne urge the Commission to reject I&M's proposed finding regarding capacity settlements and to instead use the test year receipts. IG opposes tracking of capacity settlement payments/receipts but otherwise takes no position on this issue. These parties' exceptions should be rejected.

While Fort Wayne concedes that the test year receipts are a fact, sufficiently established in the record by simple recitation, Fort Wayne argues that the need for the adjustment has not been adequately established with fixed, known and measurable data. This latter point is not correct. As discussed in I&M's Proposed Order, the record and further discussed below,

[12] *See* this Reply Brief at 34-35.

[13] The methodology for determining the "fair return" on the fair value is two-part. First, under I&M's proposal, the authorized net operating income is calculated by multiplying I&M's proposed WACC by I&M's net original cost rate base. Second, the overall "fair return' by adding a modest return on the "fair value increment" to the revenue requirement.

undisputed facts establish that the test year capacity settlement receipts are not representative of current or future results. Therefore, the test year operating results must be adjusted. The question is how?

The options are straightforward: use the actual results for the adjustment period; use weather normalized data for the adjustment period; or track the capacity settlement payments/receipts.

Fort Wayne's objections rest on its desire for more back-up information about the normalization. This is what the discovery process is for. Fort Wayne does not contend that information it sought through discovery was not provided. While the actual adjustment period results could not have been known at the time I&M pre-filed its case-in-chief in September 2011, both the tracking alternative and the potential for a change was correctly identified in I&M's initial pre-filing. The purpose of the bifurcated hearing process is to permit the parties and the Commission to have ample opportunity to explore the status of the Company's operations and rate increase needs. Furthermore, the actual data was provided to the other parties well in advance of their own prefiling and the final evidentiary hearing. Moreover, the Commission's decision must consider the totality of the evidence.

Normalizing for the impact of weather and similar conditions is common in rate cases. Given the opposition to the normalization proposal, it is reasonable for I&M to focus on the alternative of using the actual data or establishing a tracking mechanism.

Fort Wayne and the OUCC arguments about the need for more proof lack merit. Unimpeached sworn testimony of facts reflected on the Company's books and records is more than adequate proof of both data points. It is illogical to find the actual test year results have been proven but the actual adjustment period amounts have not.

The OUCC proposed finding on the AEP Pool Capacity Settlements is error ridden and does not accurately reflect the facts or properly apply the law to those facts. For example, a comparison of I&M and the OUCC's filings shows the OUCC edited I&M's summary of its evidence in this as well as other sections of the proposed order. The OUCC did not explain why it changed words like "discussed" and "explained" to words like "suggested" or "claimed" but it appears the OUCC did so to try to cast doubt on I&M's testimony or imply a meaning different than that expressed by the witness. In particular, I&M's Proposed Order accurately summarized Ms. McLravy's testimony explaining that I&M's normalized Member Load Ratio ("MLR") (0.19499) is higher than I&M's average test year MLR (0.19216) and reflects normalized peaks during the year, normal weather and the "<u>continued effect of the varying pace of economic recovery</u> across the eastern companies of the AEP System during the twelve months following the end of the test year." IMPO, at 96. In the OUCC version, the OUCC changed the phrase "continued effect of the varying pace" to "the variable effects of economic recovery." OUCCPO, at 101. Ms. McLravy's point here is that there is a varying pace among the different eastern operating companies who are members of the AEP Pool. The words "variable effects of economic recovery" twists this testimony and suggests that the economy is recovering but has variable effects. Even if the economy is recovering as the OUCC rewrite claims and not flat as suggested by the record evidence, Ms. McLravy's point remains -- each operating company and service area recovers at a different pace.

The OUCC edits are especially jarring in the summary of the evidence about the three events that changed the level of capacity in the AEP Pool. I&M's Proposed Order accurately reflects that Ms. McLravy identified three events that changed the level of I&M capacity settlement receipts: (1) the retirement of Ohio Power Company's ("OPCo") Sporn Unit 5 in

September 2011; (2) the merger of Columbus Southern Power ("CSP") into OPCo on December 31, 2011; and (3) the completion of the Dresden Gas Plant as an addition to Appalachian Power Company ("APCo") capacity that occurred January 31, 2012. IMPO, at 96. In the OUCC version the word "identified" is changed to "discussed" and the word "that" is replaced with the phrase "which she claimed." OUCCPO, at 101. These edits imply that these are not matters of fact when these matters did in fact occur. It is also a fact that the AEP Pool capacity settlement payments and receipts are the product of a formula in the FERC-approved AEP Interconnection connection agreement. It is a fact that the three changes occurring in I&M's sister companies changed the level of I&M's capacity settlement receipts as proven by the actual capacity settlements that occurred following these three events.

Similarly, Ms. McLravy did not "suggest" the test year and adjustment period results are known. OUCCPO, at 101. She accurately testified to the simple fact that they "are known." Likewise, Ms. McLravy did not "suggest" that I&M's actual net capacity settlement receipts/payments of $30.8 million for the twelve months ended March 2012 are much lower than the test year receipt of $60.7 million. She accurately represented obvious and readily verifiable facts. Ms. McLravy did not "suggest" that as of the end of the adjustment period I&M was making capacity payments to the Pool. She stated this for what it is -- a matter of fact. None of this readily verifiable data was impeached.

Notably, Ms. McLravy did <u>not</u> testify that the retirement of Sporn Unit 5 and the addition of Dresden impacted the MLR. OUCCPO, at 103. The OUCC statement to the contrary confuses capacity with MLR even though Ms. McLravy dispelled this notion repeatedly on the witness stand. Tr. F-77, 85-86; Tr. EE-28-46. In her rebuttal testimony, she also explained that changes in capacity do not impact the MLR. McLravy Rebuttal, at 5, fn. 1. Rather, changes in capacity owned by the operating companies impact I&M's relative surplus/deficit position in the AEP Pool and this in turn impacts the level of the capacity settlement. But changes in capacity do <u>not</u> impact the MLR.

When the facts are recognized and the difference between capacity and MLR is understood, the first of the two questions posed in the OUCC proposed finding is erroneous. Because capacity changes do not impact the MLR, obviously the MLR should not be updated based on the plant additions and retirements. Instead, I&M’s test year level of capacity settlement receipts should be updated because unimpeached facts of record demonstrate that a) the actual capacity settlement receipts in I&M’s test year ($60.7 million) are much higher than the actual capacity settlement receipts for the adjustment period ($30.8 million); b) this change was driven by changes in the capacity owned by I&M’s sister companies and the impact of those changes on I&M’s relative surplus/deficit position in the AEP Pool; and c) I&M's relative surplus/deficit position in the AEP Pool will not revert to the test year level. Therefore, the test year capacity settlement receipts are not representative of the receipts that I&M received during the adjustment period and are not representative of the receipts that I&M will receive during the period the rates fixed in this proceeding will be in effect. Consequently, the question is whether the actual fixed, known and measurable receipts during the adjustment period should be used for ratemaking purposes ($30.8 million) or whether something else should be done to address this issue.

The OUCC wrongly contends that I&M has provided no data that the post-test year amount is more appropriate. OUCCPO, at 103. Evidence of the actual payments reflected on I&M’s books and events that actually occurred are plenty of proof.

The OUCC discussion of energy levels (OUCCPO, at 103) also makes no sense. The MLR has nothing to do with capacity that "goes onto or comes off the grid." OUCCPO, at 103. The MLR is not about energy. The MLR reflects the amount of capacity each company needs to serve its peak load. When a company hits a peak, this fact can significantly change a company's MLR.

The OUCC discussion of a Renewable Wind Energy Project Power Purchase Agreement "REPA" approved by the Commission reflects matters that are not of record (OUCCPO, at 103-04) and the harshness of these accusations is striking given the invalidity of the OUCC's claims. The REPA does not change the MLR as the OUCC suggests (OUCCPO, at 104) because (as explained above), the MLR reflects the level of capacity an operating company needs to serve its peak load. Regardless, the 40 MW of capacity from the 100 MW REPA will not start until the beginning of 2013, a date that is well outside the adjustment period (which ended March 31, 2012). It is not appropriate to reflect this small capacity addition in this case for the same reason that it is not appropriate to reflect the loss of capacity resulting from the planned retirement of Tanners Creek Unit 4. While these events are reasonably expected, both are known to occur well *outside* of the adjustment period. That said, approval of the capacity settlement tracker as set forth in I&M's Proposed Order would permit the REPA "as well as other events that may change the level" of capacity settlement payments/receipts to be recognized on a fair and even-handed basis that does not pick winners or losers. IMPO, at 96; McLravy Direct, at 11, McLravy Rebuttal, at 2; Tr. F-90. Accordingly, the Commission should cast aside both the OUCC's critical judgment and its implication that Ms. McLravy took an incomplete approach to her calculation.

The OUCC and Intervenor filings go on at great length to cloud these matters, but the simple facts remain. It is well established that test year operating results are adjusted for changes that are fixed in time, known to be occurring and measurable in amount. The capacity settlement payments/receipts reflected on I&M's books for the twelve months following the test year represent a text book fixed, known and measurable change and clearly demonstrate that the test year operating results are not representative of current or future operations. As a result, the test year results must be replaced. In lieu of replacing the actual test year operating results with the actual adjustment period results, I&M proposed the Commission use a normalized result, or better yet, address this volatile component of the revenue requirement via a tracking mechanism.

IG opposition to the tracker does not justify its rejection. IGE, at 7. As discussed above, the amounts at issue are substantial and variable. As also discussed above, the MLR reflects the level of capacity an operating company needs to serve its peak load. Peak load requirements are driven by consumer demand, not AEP management decisions.

Accordingly, the Commission should reject the OUCC and Intervenor proposed findings and instead either approve the normalized revenue credit based on the adjustment period actual results or authorize the implementation of a capacity settlement tracking mechanism as set forth in I&M's Proposed Order (at 95-96, 98-99).

B. <u>Reclassification of Revenues.</u> OUCC concedes that its testimony regarding this adjustment is wrong but urges the Commission to make it anyway. OUCCPO, at 106. The OUCC proposal ignores the record evidence and its arguments are contrary to law.

I&M's test year revenues are presumed to be reasonable. While I&M's audited books and records are also entitled to this presumption, unimpeached record evidence establishes that I&M's books are maintained in accordance with the Uniform System of Accounts and Generally

Accepted Accounting Principles. Krawec Direct, at 3. As the proponent of the adjustment to test year revenues, the OUCC carries the burden of proof. The OUCC has not established that the revenues it seeks to impute were incorrectly booked to a below-the-line account.

Furthermore, the OUCC's attachment to I&M's revenues is wrong as a matter of law. Customers pay for retail electric service. They do not pay for, or acquire rights in, individual cost components reflected in the revenue requirement used to establish the rates. Likewise, they do not retain rights to the dollars they pay to the utility for the provision of retail electric service. In rejecting a similar imputation argument, the Minnesota Supreme Court in *Minnegasco v. Minnesota Pub. Util. Comm'n*, 549 N.W.2d 904, 909, 169 P.U.R.4th 405, 409 (Minn. 1996), explained that customers purchasing utility service:

> [A]re no different in that regard than any consumer who purchases a product from a business. The simple act of purchasing a product or service from a business does not mean that the consumer becomes an owner of any of the business' assets.

As explained by the Minnesota Supreme Court, this conclusion is consistent with Justice Marshall's observations in his concurring opinion in *Pacific Gas & Elec. Co. v. Public Util. Comm'n. of California*, 475 U.S. 1 (1986), which explained:

> [A] consumer who purchases food in a grocery store is paying for the store's rent, heat, electricity, wages, etc., but no one would seriously argue that the consumer thereby acquires a property interest in the store. That the utility passes its overhead to ratepayers at a rate fixed by law rather than the market cannot affect the utility's ownership of its property . . . .

Id., 475 U.S. at 22 n. 1 (Marshall, J., concurring). The U.S. Supreme Court opinion in *Board of Public Utility Com'rs v. New York Tel. Co.*, 271 U.S. 23 (1926), long ago established that:

> Customers pay for service, not for the property used to render it. Their payments are not contributions to depreciation or other operating expenses or to capital of the company. By paying bills for service they do not acquire any interest, legal or equitable, in

> the property used for their convenience or in the funds of the company. Property paid for out of moneys received for service belongs to the company just as does that purchased out of proceeds of its bonds and stock.

271 U.S. at 32. This principle was succinctly recognized by the Commission in *Re Indiana Gas Co., Inc*., Cause No. 38302, 93 P.U.R.4th 80, 82 (IURC 4/27/88). There, the Commission (quoting *New York Telephone Co*.), stated that "[t]he revenue paid by the customers for service belongs to the [utility]. The amount, if any, remaining after paying taxes and operating expenses including the expense of depreciation is the company's compensation for use of its property."

In sum, the OUCC exception is wrong on the facts and the law. Therefore, the OUCC proposed finding and its imputation of revenues must be rejected.

C. Carbon Capture and Storage ("CCS") Research and Development Costs.

Substantial record evidence demonstrates the following, with little, if any, dispute:

- Carbon Capture and Storage ("CCS") technology will increase use of Indiana coal in a carbon regulated environment;[14]
- Research and development must be undertaken if CCS is to become a viable technology;[15]
- The federal Environmental Protection Agency ("EPA") has and continues to promulgate numerous regulations limiting emissions from coal-fired power plants, including the Rockport Station, and such regulation increasingly trends toward regulation of carbon emissions from coal-fired power plants; [16]
- Coal may reasonably be expected to be a dominant energy source for the country for decades to come because of its abundance and versatility;[17]
- The CO_2 sequestration work undertaken by I&M will enable I&M to keep the Rockport Plant viable and burn Indiana coal.[18]

[14] *E.g.*, Chodak Direct, at 23-24; Chodak Rebuttal, at 22; Tr. CC-50-51.

[15] *E.g.*, Chodak Direct, at 23-24.

[16] *E.g.*, Chodak Direct, at 4, 19-20; Tr. CC-85, 88, 166-168; Armstrong Direct, at 10-12, 18, 21-22; Tr. T-8-11.

[17] *E.g.,* Chodak Direct, at 24.

[18] Tr. CC-50, 60, 65, 126-129.

- The Commission has previously found that research and development ("R&D") directed toward finding ways to minimize the environmental impact of coal is necessary.[19]

- The test year R&D costs I&M incurred are a fraction of the total cost of the CCS R&D project;[20] and

- Although the retail jurisdictional cost is only 7.5% of the total cost, I&M (and its customers) will receive 100% of the benefit of the CCS R&D effort.[21]

This record evidence is a textbook example of R&D costs that are allowable for ratemaking purposes.

The OUCC, IG and SDI urge the Commission to exclude the test year R&D costs for ratemaking purposes. OUCCPO, at 114; IGE, at 37-38, SDIE, at 111-12. These proposals contravene the legislative mandate that the Commission "shall allow" such R&D costs for ratemaking purposes as an operating expense. Ind. Code §8-1-2-6.1(c) (the "R&D" Statute). By using the term "shall" in the statute the General Assembly established a mandatory requirement. *Hancock County REMC v. Greenfield,* 494 N.E.2d 1294, 1295, (Ind. Ct. App. 1986) *reh. den.* (1986). The Commission does not have discretion to find that it is excessive to reflect a reasonable level of qualifying R&D costs in the revenue requirement because the General Assembly has mandated otherwise. The arguments to the contrary are a smoke screen. *See* OUCCPO, at 112-114.

First, the OUCC contends the R&D costs can be excluded for ratemaking purposes because the costs were incurred for a project located out-of-state and not included in I&M's rate base. OUCCPO, at 107. This claim is factually and legally flawed. The disputed test year R&D

[19] *Re Duke Energy Indiana*, Cause No. 43114 IGCC 1 (IURC 1/7/2009), at 27.

[20] *E.g.,* Chodak Direct, at 24.

[21] *Id.*

costs were incurred by I&M to explore the potential use of CCS at the Rockport Plant, which is located in Indiana and is reflected in I&M's revenue requirement. The fact that the R&D activity was performed elsewhere does not change the fact that the potential "project", *i.e.*, CCS at Rockport Station, is located in Indiana. No language in the R&D statute or regulation limits R&D efforts to activities performed within Indiana. Furthermore, the Commission has previously found that there is "not a 'used and useful'" requirement associated with R&D activities. *Re Duke Energy Indiana*, Cause No. 43114 IGCC 1 (IURC 1/7/2009) at 28. Hence, the OUCC's "rate base" argument and SDI's attempt to distinguish the decision reached in the Duke case are *non sequiturs*. OUCCPO, at 108-109; SDIE, at 111, n. 8.

Second, the OUCC suggests the R&D statute should prohibit costs incurred for a joint R&D effort. The plain language of the statute does not support this argument. Common sense tells us that joint R&D projects should be encouraged as a matter of regulatory policy. R&D is very costly. By joining with others to help research and develop CCS technology, I&M and its customers receive 100% of the R&D results, for a small fraction of the total cost.

Third, the OUCC contends that discretion to wholly exclude the test year R&D costs challenged in this case may be found in subsection (e) of the statute. Ind. Code §8-1-2-6.1(e). This statutory language does not empower the Commission to nullify the legislative mandate that R&D costs shall be allowed for ratemaking purposes. Moreover, the Commission's promulgated rules establish that R&D costs are recoverable for ratemaking purposes if the cost level is reasonable. 170 IAC 4-6-17. Here, the level of R&D costs reflected in the revenue requirement is $520,798.[22] This pales in comparison to $17 million R&D CCS effort the Commission found to be reasonable and recoverable for ratemaking purposes in *Re Duke Energy Indiana,* Cause No.

[22] This reflects a two year amortization of the test year cost.

43114 IGCC 1 (IURC 1/7/2009) at 28. I&M and its customers will receive 100% of the R&D for a small fraction of the total cost of the work. By any credible measure, the level of R&D costs reflected in the revenue requirement is reasonable.

Fourth, the OUCC urges the Commission to "agree with the OUCC" that the CCS R&D work is "too location-specific to necessarily translate to any of I&M's coal-fired facilities." OUCCPO, at 113. The OUCC suggestion that the Commission should reject the substantial credible expert testimony of Mr. Chodak[23] on this issue and reject the CCS R&D costs based on the OUCC's speculation is incredulous and should be rejected.[24] *See* IMPO, at 103.

The record reflects that the purpose of the CCS R&D work is to evaluate design options, define the system, equipment sizes and specifications, develop a detailed cost estimate and evaluate the benefits of installing CCS on American Electric Power coal-fired power plants. Chodak Direct, at 23. Ms. Armstrong conceded that she had no basis to disagree with Mr. Chodak's expert testimony. Tr. T-23. Mr. Chodak testified that the CCS FEED Study is directly transferable to I&M's Rockport Plant because the Rockport Plant operated by I&M is of the same design as the Mountaineer plant that was the subject of the FEED study. Chodak Direct, at 23; Tr. CC-68, 168. Ms. Armstrong testified that she does not disagree that the boiler designs are the same and the size of the facility is the same. Tr. T-24. Ms. Armstrong was unable to

[23] Mr. Chodak's educational and professional background is extensive and includes a Doctorate Degree in nuclear engineering from Massachusetts Institute of Technology, a Master's Degree in civil engineering from Virginia Polytechnic Institute and State University, and a Bachelor of Science Degree in chemical engineering with honors from Worchester Polytechnic. Chodak Direct, at 1-3. His professional experience includes extensive work in technology development, including the evaluation of pollution control technologies, management of capital investments made to comply with environmental regulations and construction of power plants. *Id.* The substantial and lengthy cross-examination of Mr. Chodak establishes that he is a knowledgeable and credible expert. There is no legitimate reason to disregard this sworn testimony because the witness has not been discredited, impeached or refuted by competent evidence.

[24] IG also contends transferability is "questionable" due to geographic issues asserting that there is an "absence of some indication" that Rockport can support CCS and "no indication" that the Mountaineer stating "was designed or undertaken" to support Indiana Coal. IGE, at 37. These arguments, which largely mirror those of the OUCC, fail for the same reasons described with respect to the OUCC arguments.

identify any differences between the facilities that would affect the transferability of the FEED Study results. Tr. 25-26. Although she offered speculation in her prefiled testimony and during cross-examination, Ms. Armstrong conceded that she does not know if the studies would be transferable. Tr. T-25-26, 43.

Substantial record evidence refutes the idea that the FEED Study Costs are not transferable to the Rockport Plant because of speculation about geographic issues. IMPO, at 112. Mr. Chodak testified that the FEED Study concerned technology that reduces the cost of running carbon capture and sequestration; geology is just one small piece. Tr. CC-65-66. Mr. Chodak explained that the more important and very onerous part of the project is the development of the actual carbon capture technology. Tr. CC-66. He also explained that geology and the need to sequester it right at the Rockport Plant is not at all critical because CO_2 may be transported to locations hundreds of miles away. Tr. CC-161-165. The record reflects that there are facilities that pipe CO_2 to remote locations today and the Department of Energy is looking at a project that would include a 440-mile CO_2 pipeline to pipe CO_2 from Rockport down to Mississippi. Tr. GG-90.

IG suggests the R&D costs should be rejected because the Rockport Plant does not currently burn Indiana coal. IGE, at 37. The R&D Statute is not limited to plants that currently burn Indiana coal or to technology that may also be used in other states. Rather, the intent of the statute is to increase use of Indiana coal. The record shows that the CO_2 sequestration work undertaken by I&M will enable I&M to keep the Rockport Plant viable and burn Indiana coal. Tr. CC-50. Thus, this R&D effort is designed to increase use of Indiana coal.

The Commission cannot ignore the sworn testimony of I&M's witnesses that the CCS R&D effort is transferable, that geographic concerns are not a critical issue, and that the project is beneficial to I&M and its customers for many reasons, including the fact that I&M and its customers receive the benefit of 100% of the work effort for only a small fraction of the total cost.[25] Therefore, the opposing parties' opposition to inclusion of the R&D costs in I&M's revenue requirement must be rejected.

The OUCC's focus on the fact that additional site specific work remains to be performed on the project is beside the point. Of course there is more work to be done. That is the nature of R&D. The OUCC position obscures the fact that <u>all</u> of the R&D work is required to pursue CCS at the Rockport Station. By participating in a joint project, I&M has secured a substantial benefit for itself and its customers for a fraction of the cost. Hence, the fact that more work might be necessary in the future, does not justify the exclusion of the reasonable level of R&D cost reflected in the Company's revenue requirement.

Fifth, other parties urge the Commission to reject the test year R&D costs because they claim the Virginia and West Virginia commissions have not been supportive of this effort. OUCCPO, at 108; SDIE, at 111. The R&D Statute mandates cost recovery, notwithstanding the policies and decisions of legislators and regulators in other states. Moreover, Virginia has been supportive of such R&D activities. The July 15, 2010 Final Order in *Re Appalachian Power Company*, Case No. PUE-2009-00030, 2010 Va. PUC LEXIS 398, *37 (VCC 7/15/2010) states that "[i]t is reasonable for AEP to evaluate and explore options regarding potential federal legislation or regulation regarding GHG [greenhouse gas] emissions." Petitioner's CX-6, p. 13; Tr. T-37-38. The costs that were presented and subsequently rejected for ratemaking purposes in Virginia were the costs of the pilot or demonstration project, which Ms. Armstrong conceded

[25] *Re Indiana Michigan Power Company,* Cause No. 39314 (IURC 11/12/1993) at 5; *West Ohio Gas Co. v. Public Utilities Comm'n of Ohio*, 294 U.S. 63, 68, 72 (1935); *Ohio Utilities Co. v. Public Utilities Comm'n of Ohio*, 267 U.S. 359 (1925); *State v. Cole*, 427 So.2d 9, 11 (La. App., 4th Cir. 1983); *City of St. Petersburg v. Vinoy Park Hotel Co*., 352 So.2d 149, 151 (Fla. Dist. Ct. App. 1977); *State ex. rel. Purcel v. Green*, 134 N.E.2d 154, 156 (Ohio 1956).

was different from the CCS FEED study. Tr. T-16-17, 38. The OUCC reliance on the West Virginia Commission decision is also flawed because that decision concerned the pilot project costs, not the CCS FEED Study costs. *Re Appalachian Power Company and Wheeling Power Company*, Case No. 10-0699-E-42T, 2011 W. Va. PUC LEXIS 704, *108, *176 (WVPSC 3/30/2011) Final Order at 44-48; *see also* Armstrong Direct, at 4, 7-8; Tr. T-39-41; Smith Direct, at 25; Chodak Rebuttal at 24; Tr. CC-154, 157.

Sixth, the other parties compel the Commission to exclude the CCS R&D costs because they claim these are Mountaineer costs. OUCCPO, at 108 - 109; SDIE, at 108, 111 – 112; IGE, at 36 – 37. This is a red herring. The test year R&D costs reflected in the revenue requirement are I&M's allocated share of the R&D activities. I&M has not included costs allocated to its sister companies.

Finally, IG argues that the costs are properly excluded for ratemaking purposes because the R&D project was not pre-approved by the Commission. IGE, at 37. The contention lacks merit. The R&D Statute does not impose a pre-approval requirement but instead directs that such costs are recoverable as an operating expense for ratemaking purposes. Specifically, Ind. Code § 8-2-2-6.1 (c)(1) provides in pertinent part that: "the commission shall allow a utility to recover as operating expenses those expenses associated with (1) research and development designed to increase use of Indiana coal …." This section does not mandate that a company seeking to recover such costs obtain prior approval for an R&D project. 170 IAC 4-6-17 provides in pertinent part that a utility "may classify research and development expenses as operating expenses and record these expenses in a deferred account. The utility may seek ratemaking treatment for a reasonable level of these research and development expenses in a general rate case." This regulation does not impose a pre-approval requirement.

D. <u>Dry Cask Canisters, including Dry Cask Storage.</u> The OUCC suggests the Commission has authority to disallow this expense in order to "encourage" desired utility action. OUCCPO, at 117. This proposal must be rejected as a matter of law. The "commission is not the financial manager of the [public utility] corporation, and it is not empowered to substitute its judgment for that of the directors of the corporation; nor can it ignore items charged by the utility as operating expenses, unless there is an abuse of discretion in that regard by the corporate officers." *Columbus Gaslight Co. v. Pub. Serv. Comm'n.,* 193 Ind. 399, 404, 140 N.E. 538, 540 (1923), quoting *Utilities Co. v. Springfield Gas Co*., 291 Ill. 209, 234, 125 N.E. 891, 901 (Ill. 1919).

The record shows there is no dispute that it is reasonable and necessary for I&M to incur dry cask storage expense. OUCCPO, at 117 (conceding no dispute on this point). The record also shows that the Company has been diligent in its efforts to offset these costs with government funds. Therefore, there is no abuse of discretion that would permit these test year expenses to be wholly excluded for ratemaking purposes.

The issue about Dry Cask Canister Expense is not whether the expense is non-recurring, but whether the expense level incurred during the test year is representative of the ongoing amount to be embedded in the annual revenue requirement. The record is not incomplete. Rather, it clearly establishes that the dry cask canister expense incurred during the test year will be incurred approximately every three years. IMPO, at 106. This is why I&M amortized the test year expense over three years and why I&M's proposed finding on this issue should be accepted.

Finally, I&M's Proposed Order also addressed the Dry Cask Storage Project cost issue and explained that the OUCC proposal to eliminate $1,147,665 (Indiana Jurisdictional) from I&M's test year O&M should be rejected because these costs were not recorded to test year

O&M expense. IMPO, at 107. The OUCC proposal that the Commission reduce I&M's test year O&M ignores the unimpeached evidence establishing this fact. As a result, the OUCC proposed finding cannot be accepted. To conclude otherwise would be arbitrary and capricious.

E. **<u>Major Storm Expense.</u>** The OUCC's proposal to establish the *pro forma* level of major storm expense based upon a five-year average should be rejected. OUCCPO, at 125. SDI concurred with the OUCC's recommendation and that position should be rejected for the same reasons discussed below with respect to the OUCC positions. Before addressing the merits of these arguments, I&M notes that its summary of its evidence has been edited, with, for example, words such as "suggested" and "theorized" being inserted in place of the Company's recitation of facts. These changes appear intended to distort the record evidence and should be rejected.

The OUCC claims that I&M has not "adequately or convincingly" explained why five years is less representative than a three-year average. OUCCPO, at 124. To the contrary, it is the OUCC, not I&M, which proposed use of a normalization period that would result in a non-representative *pro forma* level of expense. That conclusion results from the OUCC's improper application of the normalization process routinely used to ameliorate the impacts of abnormally high or low expense levels in specified periods, both with respect to its effort to dismiss the validity of using a consistent approach to determine a representative *pro forma level* and its recommendation to use a normalization period which unfairly skews the level of costs to achieve a particular result.

The OUCC seemingly rejects out of hand the concept that application of a consistent normalization period will result in a representative level of expenses, claiming that the Commission's prior adoption of a three-year average to determine a representative level of expenses "does not in any way bind" the Commission to use a similar timeframe in this case and that the focus is "not on consistency but on finding a methodology that will yield a representative level of major storm expense." OUCCPO, at 125. By narrowly focusing on whether the Commission is or is not bound to a prior methodology, the OUCC misses the simple fact that a consistent approach does result in a representative level of major storm expenses.

For example, if the period were modified each time a case is developed or litigated, it could result in the expense level being unrepresentative over time. Furthermore, use of a consistent methodology for normalization alleviates concerns that the normalization period was chosen to unfairly skew the level of costs in the revenue requirement to achieve a particular result. IMPO, at 109; Krawec Rebuttal, at 34-35. That is, if one continually tries to manipulate the expense amount by clawback to capture a low period or to eliminate a high period, the true picture may never be captured. Use of a consistent approach recognizes that gaming the calculation to obtain a particular expense level is not correct. Krawec Rebuttal, at 35-36. I&M is not alone in recognizing the merits of using a consistent approach, and, in fact, ample precedent exists to demonstrate recognition of the benefit of following a consistent approach and that the use of a consistent normalization methodology is reasonable.[26]

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[26] *See Southern California Edison*, 1984 Cal. PUC LEXIS 1050, 105-106 (Cal. PUC 1984) (Edison notes that a five-year historical average has been the consistently used and adopted estimating methodology for storm damage expense for at least two prior Edison general rate cases. We see no reason to change to a seven-year average. Also, there is a need to be consistent regardless of whether a five-year or seven-year average is used. Accordingly, we will be consistent and use the latest five-year average which includes 1983 recorded.); *Delmarva Power & Light*, PSC Docket No. 05-304, 2006 Del. PSC LEXIS 121, 47-49 (Del. PSC 2006) (The Company asserted that a three-year normalization period for injuries and damages ("I&D") and storm restoration expenses is appropriate because Staff and the DPA accepted that period in the Company's last gas base rate case, Docket 03-127. The Hearing Examiner recommended that the Company's proposed three-year normalization period for I&D and storm restoration expenses be accepted. Staff, which was the only party to contest the Company's proposed normalization periods for these expenses, did not except to the Hearing Examiner's findings and recommendations. Therefore, we adopt the Hearing Examiner's recommendation.); *United Telephone Company*, Docket No. 750316-TP (CR), Order No. 7109, 1976 Fla. PUC LEXIS 464 (Fla. PUC 1976) (In keeping with Commission policy and to be consistent with the Company's last rate proceeding, it is appropriate to average these storm damage losses over a five year period. By making this adjustment, the test year is also made more representative of future operations.); *Louisville Gas and Electric*, Case No. 2003-00433, 2004 Ky. PUC LEXIS 525 (KY PSC June 30, 2004) (LG&E proposed to normalize its storm damage expense by using a 10-year historic average adjusted for inflation. LG&E stated that this was the same methodology utilized by the Commission in Case No. 1990-00158. While the Commission agrees with the methodology used by LG&E, the inflation factor was not determined in a manner consistent with the

The problems associated with not using a consistent approach are not hypothetical matters for consideration. Rather, the very drawbacks I&M identified could happen in the absence of a consistent approach, and do arise in the approach advocated by the OUCC (as well as SDI and the IG). That is, as explained below, the approach recommended by the OUCC is a results-driven methodology which results in a *pro forma* storm expense level that unfairly skews the calculation as a result of which data points (annual expense levels) are included.

The OUCC posits that it is "well understood that an average that consists of more years tends to produce a number that in the long run should be less likely to overstate or understate a cost." OUCCPO, at 125. The notion that an average consisting of more years automatically creates a more representative picture is incorrect. The validity of an average is only as good as the inputs used to develop that average. An average can be manipulated by omitting data or by so diluting the impact of a particular data point as to eviscerate rather than to ameliorate its impact. The record in this case demonstrates that the OUCC's average is built on a search for the average that will result in a lower, and therefore, non-representative level of expenses.

First, OUCC witness Michael D. Eckert offered results based on three different formulas and then recommended that the Commission adopt the five-year formula, the one resulting in the lowest average level of expenses. OUCCPO, at 119. Second, the OUCC incorrectly dismisses the record evidence showing that a destructive storm occurs every three years, claiming that "there is simply not the scientific evidence presented in this case to support such a premise" and that Mr. Krawec "made no mention of a particularly destructive storm since 2008." OUCCPO,

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approach used by the Commission in previous cases. The inflation factor previously used by the Commission is based upon the Consumer Price Index -- All Urban Consumers ("CPI-U") (n.77). To determine the inflation factor for a particular year, the Commission divides the CPI-U for the base year by the CPI-U for the particular year (n. 78). The Commission has recalculated the storm damage expense adjustment using the inflation factor approach previously utilized, and determined that LG&E's storm damage expense should be increased by $83,765.).

at 124. The OUCC's reference to needing "scientific evidence" is misplaced and its omission of a 2011 (as well as a 2012 event) is also telling. The appropriate standard is substantial record evidence and I&M has met that standard. I&M provided record evidence demonstrating that destructive storms occurred in 2005 and 2008. IMPO, at 108, 110. Specifically, I&M Witness J. Edward Ehler testified that during 2011 a single major storm cost approximately $1.2 million, an amount representing over half of the approximately $2.3 million adjustment sought by I&M in this case. IMPO, at 108. On June 29, 2012, another major storm occurred, resulting in projected expenses exceeding $12 million, an event of which the Commission may properly take judicial notice.[27] As I&M demonstrated in footnote 9, page 111 of its Proposed Order, if one were to assume that 2006 expenses were at least $0.9 million (the lowest expenses for any year in the record) and that 2013 expenses will be at least the $12 million reported in the press, the annual average major storm damage expenses from 2005 thru 2013 would be at least $6 million per year. Recognition of the full range of events demonstrates that there are indeed significant cost impacts associated with destructive storms such of those experienced by I&M. Moreover, the timing of these events corroborates I&M's testimony that significant events occur on a three year cycle, the normalization period proposed by I&M.

The OUCC's omission of the high cost events is telling, particularly in light of its position that averages based on "more years" carries additional validity. Simply put, the OUCC cannot have it both ways, arguing that more data points provide more valid results but then

[27] The IG objected to the Commission taking notice of the cost of this storm as reflected in the newspaper articles cited in footnotes 7 and 8 of I&M's Proposed Order. IGE, at 40. In support of its exception, the IG states that the figure "is based on information presented to the media by an I&M spokesman" and also claims that it does not comport with the requirements of Indiana Rule of Evidence 201. The fact that a major storm causing a large number of customers to lose power and imposing a costly restoration project on I&M is generally known within the jurisdiction and accurately and readily determined from the referenced media source. In its Proposed Order, I&M did not seek to adjust the revenue requirement to reflect these costs. Rather, I&M pointed out this event because it shows the record evidence establishing that I&M's service area tends to be hit by a major storm every three years continues to be accurate.

excluding those data points representing higher expense levels while including all the lower amounts. To do so guarantees that the "average" will always result in a lower *pro forma* level, which certainly cannot be considered representative of expenses incurred in the normal course of operation.

In an additional inconsistent argument, the OUCC seeks to justify its position by reference to the most recent three-year period, stating that "Petitioner's methodology does not explain why a three year average using the three most recent years of data we have would not be just as valid…." OUCCPO, at 119. The OUCC's reference to yet another period suffers from the same flaws discussed above. First, reference to yet another period undermines the benefits of a consistent approach identified above. Second, reference to this period, which the OUCC recognizes results in an "unreasonably low estimate," presents yet another example of a results-oriented approach, in this instance another search by the OUCC's for a period that will result in a biased low amount. Finally, it ignores substantial record evidence demonstrating that on average, I&M's major storm expense substantially exceeds the cost incurred in this period.

In defending the use of a five-year average, IG takes an approach similar to the OUCC, asserting that I&M's approach "suffers from a significant infirmity, namely the utilization of a small set of data which includes an evident, dramatic abnormality." IGE, at 39. It also proposes the same remedy as the OUCC, expansion of the range of data to reduce the effect of 2009 expense levels by using a five-year average based upon the period 2007 through 2011. IGE, at 39. To the contrary, the five-year period IG advocates does not constitute the "reasonable representation" it claims. IGE, at 40. By its own admission, the IG's expansion of data ranges is incomplete as it specifically excludes a year with a large expense level. IGE, at 40. In defense of such exclusion, the IG offers the illogical rationale that it "fail[s] to see how including another abnormally large storm expense year in the average assists in ascertaining a reasonable representation of I&M's normal storm damage expense." IGE, at 40. At the same time, however, the IG has no similar qualms about including three years at the opposite end of the spectrum. IGE, at 40.

It is simply illogical for a party advocating an expanded data set to expressly exclude a single high year while including three years that it recognizes represent the lowest range of the spectrum. The juxtaposition of these two positions – exclusion of the high level and inclusion of the lower levels – cannot be reconciled with the IG's conclusion that its approach "captures a broader and more balanced range." IGE, at 40. To the contrary, the IG approach results in an average skewed in favor of achieving a lower *pro forma* expense level.

For the reasons stated above, the Commission should reject the opposition to the Company's use of a three-year average of major storm expense using the three-year period ending March 31, 2011.

In response to the OUCC's request that I&M consistently file and retain the storm outage reports pursuant to 170 IAC 4-1-23 (b)(1), the record shows the Company already sends reports, is not aware of any complaints from Commission or its Staff regarding such reports, and an inability to produce two reports in a six year period is not a reason for concern, especially when there is no requirement to retain a record of filed reports. Chodak Rebuttal, at 25. The OUCC argument about accuracy ignores the real time nature of reports and evidence showing I&M goes above and beyond in the preparation of its materials. Chodak Rebuttal, at 25-26. Finally, in response to the OUCC's request that it also receive reports, the record reflects that I&M is "amenable to providing" the documents. Chodak Rebuttal, at 26. Accordingly, no special or additional reporting requirements need to be imposed.

F. Major Storm Restoration Reserve. Objections by the OUCC and IG to I&M's proposed storm reserve largely rest on assertions that the Company is seeking to guarantee cost recovery (IGE, at 42, OUCCPO, at 132, 134), shift risk or consequences of certain actions from shareholders to customers (IGE, at 43, OUCCPO, at 133, SDIE, at 132), create an incentive to delay the filing of a rate case or maintaining an adequate workforce (IGE, at 44, OUCCPO, at 133) and constitute single issue ratemaking (SDIE, at 132) do not withstand scrutiny.

No cost recovery guarantee is provided to the Company through the reserve. Because the review will take place in the context of a rate case, the Commission, OUCC and intervenors will have the opportunity to consider the full range of issues that may impact the manner in which rates are set and the ultimate determination of the level of those rates. IMPO, at 118. I&M's proposal is explicitly designed to include a review of any net liabilities or assets in the context of a rate case. IMPO, at 118. There is no automatic pass-through or guarantee of recovery either in-between rate cases or in the rate case. Only upon Commission review of major storm damage restoration revenues and major storm restoration expenses in a rate case and issuance of an order in that case would basic rates be adjusted to resolve any under/over recovery positions and to more closely align revenue recovery with expected expenses. IMPO, at 118-119.

With respect to claims that I&M seeks to shift risk or consequences of certain actions, such criticism is unwarranted. I&M cannot shift all risk or consequences. As explained in its Proposed Order (at 119), prudent utility management dictates that a utility take all reasonable steps to make repairs and restore service following a major storm event. To properly adhere to such a standard, I&M would necessarily have to "determine how it will prepare for such events and how it will respond to such events," the standard identified by the OUCC. OUCCPO, at 132. I&M does not seek to be excused from its obligation to engage in prudent utility management as evidenced by the fact cited above that its reserve includes a rate case review component and Commission approval before any adjustments to basic rates are implemented. Similarly, the OUCC's claim that I&M's cost reduction initiatives shift the consequences of such action to customers again ignores the Company's ongoing obligation to engage in prudent management practices. OUCCPO, at 133. That is, the OUCC is simply wrong that the Company would have a perverse incentive to employ fewer people to keep power out longer and benefit from the longer outage constituting a major event. OUCCPO, at 133. There is no evidence on the record in this case that I&M would engage in dilatory restoration practices following a storm or maintain an inadequate workforce that would adversely impact its ability to meet its obligation to provide reasonably adequate service. To the contrary, on cross examination, Mr. Krawec testified that I&M would not "purposefully delay putting customers back on line just to have this qualify as a major storm expense." Tr. FF-53. Mr. Krawec further stated that "[t]he main incentive of our company is when the lights go out, get the lights back on…That's our incentive." Tr. FF-54. He testified that this objective would be the case whether it is a regular or major storm. *Id*. Having no evidence to cite, the OUCC instead makes an unsupported supposition that I&M may do so based on a claim that it has "tried in this rate case to shift consequences of its actions (or inactions)" to customers. OUCCPO, at 133. Any evidence that the Company has not discharged its obligations would certainly be relevant in future rate cases in which the Commission is reviewing I&M actions with respect to the reserve and other matters under consideration. However, mere conjecture about what may happen does not provide a sound basis for rejecting the Company's proposed reserve.

SDI's claim (SDIE, at 131) that the reserve mechanism constitutes single issue ratemaking does not properly recognize the clear distinction previously drawn by the

Commission between ratemaking undertaken in the context of a rate case and a proposal made in the context of a stand-alone proceeding. By its very nature, a stand-alone proceeding focuses only on the specific matter under consideration in that proceeding. As the Commission noted in *Re Duke*, a rate case is fundamentally different because "[u]nlike a stand-alone proceeding such as this one, a base rate proceeding provides the tools necessary for the Commission to fully consider and evaluate ongoing expenses. *Re Duke Energy Indiana*, Cause No. 43743, Order on Reconsideration (IURC 10/19/2001) at 13.

There should be no confusion with respect to the mechanics of the reserve and the forum in which relief under the mechanism would be granted. I&M provided a comprehensive description of the mechanism starting with the calculation of any under- or over- recovery, the creation of a regulatory asset or liability based on that calculation, the accounting for these amounts, culminating in definitive statements that a general rate case would be the forum in which it would receive any adjustment to its expenses or revenues. IMPO, at 117. Given SDI's apparent lingering confusion, these express statements are repeated so that the record is clear on this matter. First, the Company has stated:

> In its next general rate case, I&M proposes to include an amortization in the cost of service developed for that case which will either reduce the cost of service for any over recovery or increase the cost of service for any under recovery at the end of the historical period. In addition, I&M will propose an adjustment to the base level of the Indiana Major Storm Damage Restoration Reserve that reflects recent historical major storm damage.

IMPO, at 112, 117. Second, I&M has stated:

> In I&M's next basic rate case filing with the Commission, the Company will summarize the major-storm damage restoration reserve revenues and the major-storm restoration expenses, and upon acceptance and order by the Commission, basic rates will be adjusted to resolve any under/over recovery positions and more closely align revenue recovery with expected expenses.

IMPO, at 112, 118. Third, I&M established that its proposal to record under- or over-recoveries on a monthly basis as a regulatory asset or liability is an accounting mechanism, providing no immediate or "mid-course" relief to the Company. Rather, the Company will implement its proposed accounting following issuance of an order in this case and in its next basic rate case filing, the Company will summarize the major-storm damage restoration reserve revenues and the major-storm restoration expenses. Once the Commission has reviewed those revenues and expenses and issued an order in that case, basic rates will be adjusted to resolve any under/over recovery positions and more closely align revenue recovery with expected expenses. IMPO, at 112, 118-119.

Therefore, for the reasons stated above and in I&M's Proposed Order and the evidence, the opposition to I&M's Major Storm Restoration Reserve should be rejected.

G. Nuclear Decommissioning Expense. The OUCC position that contributions to the nuclear decommissioning trust should be discontinued is irresponsible and unreasonably shifts the responsibility for these costs to future customers. The hyperbole offered in support of this proposed finding is incredulous.

In this Cause I&M presented substantial analysis of its nuclear decommissioning expense and supported this analysis with the expert testimony of Steve Kiser. The OUCC and Intervenor witnesses who testified on this issue all relied on I&M's study. *See* Public's Exhibit DPJ, at 7; Smith Direct, at 30; Kiser Rebuttal, at 9-19. These witnesses did not argue that the Company's study was invalid. Nor did they "argue that Petitioner has not adequately supported its case" as OUCC contends. OUCCPO, at 141. Rather, the OUCC and Intervenor witnesses disagreed with the conclusion Mr. Kiser drew from the I&M study. However, I&M showed through rebuttal and cross-examination, that the OUCC and Intervenor's position is severely flawed. *E.g.*, Kiser

Rebuttal; Tr. EE-96-99. In particular, their underlying analysis incorrectly compared 2009 dollars to 2012 dollars and fails to take into account the substantial impact of taxes on the unrealized gain on the securities held in the Trust. When these matters are taken into account, seven out of ten of the decommissioning scenarios are underfunded, including the most likely scenario, which is underfunded by approximately $340 million. IMPO, at 128. Simply put, the OUCC and Intervenor premise that most of the scenarios are overfunded is not true.

The flaws I&M identified are not subjective; they are methodologically sound. As such, this evidence does not "attempt to" refute the OUCC and Intervenor viewpoint (OUCCPO, at 141), it "does refute it" and it cannot be swept aside. The Commission long ago found that nuclear decommissioning expense should be included in the revenue requirement based on a nuclear decommissioning study. *Re Indiana & Michigan Electric Co.*, Cause No. 36760-S2 (IURC 3/23/83). The Commission should not depart from this practice based on "possibilities" or emotionally charged rhetoric, but should continue to establish nuclear decommissioning expense based on a firm factual and analytical foundation as set forth in I&M's Proposed Order.

H. Legal Expense. Two issues were raised concerning I&M's test year legal expense: (1) the adequacy of I&M's production of documentation to support its test year legal expense; and (2) an adjustment to reduce test year legal expense to eliminate expenses associated with acquisition of assets from Fort Wayne's City Light.

With regard to the first issue, OUCC Witness Stull initially proposed to remove all test year outside legal expense based on her contention I&M did not provide information necessary to evaluate the reasonableness of those costs. However, the proposed orders tendered by both the OUCC and IG appropriately acknowledge that I&M's approved rates should provide for recovery of outside legal expenses. All parties now agree that test year outside legal expenses should be reflected in I&M's revenue requirement (although there is still not agreement on the appropriateness of adjusting test year legal expense for the asset acquisition). Despite the agreement on the result, the admonitions and legal analysis proposed by the OUCC and IG are factually and legally flawed and should be rejected.

It is not appropriate for the Commission to predetermine the type of information that I&M or any other utility must provide in a future case to support its test year legal expense level as the OUCC advocates. OUCCPO, at 208. Evaluation of any expense varies from case to case and is fact dependent. Hourly rates and number of hours worked may be completely irrelevant or not tracked if a utility has a fixed-fee or alternative fee arrangement. A comparison of the legal expenses in the twelve-month period before and after the test year may result in a more representative level of ongoing expenses if an abnormal level of expenses were incurred in a test year. A variety of factors may influence the information available to evaluate the appropriateness of a cost and rendering broad conclusions about what would and would not be determinative, as proposed by the OUCC, eliminates flexibility that may be appropriate in future proceedings.

The Commission should also refrain from adopting the OUCC's proposed admonishment that I&M needs to be more forthcoming with information supporting expenses it seeks to recover. OUCCPO, at 208. I&M responded timely to the discovery requests on this issue and objected appropriately to the disclosure of confidential and privileged information. Nor is it appropriate to predetermine that not providing particular information in the future should preclude a utility from including such expenses in its rates. *Id.* The record before the Commission is incomplete concerning the efforts exerted by the OUCC and I&M to resolve concerns about the discovery process because the OUCC chose not to elevate the issue in accordance with Commission and Indiana Trial Rules. The OUCC chose instead to use an alleged failure to provide information to support its adjustment to eliminate a legitimate expense. The Commission should not reach judgment about whether one party or the other was culpable when the full details of attempts to resolve the dispute informally were never presented.[28]

Neither should the Commission adopt the IG's erroneous legal analysis of the presumed reasonableness of test year expense levels or burden of establishing a *prima facie* case. The IG contrasts I&M's assertion that historical results are *prima facie* reasonable with an earlier I&M rate order holding that the presumption in favor of a test year expense arises only after a utility establishes a *prima facie* case supporting the reasonableness and necessity of the expense. IGE, pp. 44-45 citing *Re Indiana-Michigan Power Co.*, Cause No. 39314 (IURC 11/12/1993) at 4. The suggestion is that something more than presenting test year results is required to establish a *prima facie* case. But the IG ignores the explanation of *prima facie* evidence in the order it cites: "In the absence of a showing of inefficiency or improvidence . . ., actual historic or specifically identified future expenditures by a utility cannot be merely disregarded for ratemaking purposes." *Re Indiana-Michigan Power Co.*, Cause No. 39314, p. 5. I&M's actual historic expenditures for legal expenses constitute a *prima facie* case and nothing more is required from I&M to support the reasonableness and necessity of the expense. I&M did not "fail to provide documentation supporting the level of test year legal expense" necessary to establish a *prima facie* case as evidence of its historical expenditures constituted sufficient evidence. I&M provided all information required by the MSFR and then some. Moreover, the revenue requirement here must be established based on the record as a whole.

[28] The Indiana Trial Rules, applicable to Commission proceedings through 170 IAC 1-1.1-16(a), establishes a mechanism for resolving discovery disputes and imposing sanctions upon a party that fails to comply with orders resolving discovery disputes. Had this process been followed, I&M is confident that the parties would have informally resolved this dispute as provided in accordance with Ind. Trial Rule 26(F).

The additional orders cited by the IG to support its contention "the failure of . . . any utility to produce sufficient evidence to support its expenditures will not only fail to give rise to the presumption of the validity of the expense, but will justify a finding by this Commission that such expenses are unreasonable and unnecessary" do not involve the presumption of reasonableness addressed in *Re Indiana-Michigan Power*. *Re Indiana-American Water Co.*, Cause No. 44022 (IURC 6/6/2012) at 80, rejected an adjustment to actual historic expenditures proposed by the utility on the basis that insufficient evidence was provided to support the utility's proposed adjustment. Rather than accepting the adjustment, the Commission adopted the historic expenditure for ratemaking purposes. *Re Indiana-Michigan Power Co.*, Cause No. 38728, 116 PUR 4th 1, 40-41 (IURC 8/24/1990) involved recovery of advertising expenses which are specifically exempted from the presumption of reasonableness by 170 IAC 1-3-3(a). *Re Southern Indiana Gas & Elec. Co.*, Cause No. 43406 RCRA6 (IURC 9/1/2010) at 3, involved recovery of wind power costs recovered through a tracking mechanism, not reliance on the presumption in favor of actual historic expenditures to support future rates. *L.S. Ayres & Co. v. Indianapolis Power & Light, Co.*, 351 N.E.2d 814, 819 (Ind. Ct. App. 1976) also supports the presumption in favor of actual historical expenditures by noting that "[t]he test year concept assumes the operating results during the test period are sufficiently representative of the time in which new rates will be in effect to provide a reliable testing vehicle for new rates."

I&M agrees the presumption that historical actual results are reasonable is jeopardized if a party refuses to provide information timely requested by opposing parties. I&M did not refuse to provide discoverable information; it only objected to the disclosure of confidential and privileged information and the OUCC did not contest that objection. Witness Stull herself acknowledged I&M had provided a "big hill" of information to the OUCC. Tr. U-72. I&M will continue to cooperate in discovery in future cases. While I&M strives to avoid any need to formally address a motion to compel its compliance with discovery, the Indiana Trial Rules provide for sanctions for a party found not to be cooperating in discovery, including an order that designated facts shall be taken to be established for purposes of the action in accordance with the claim of the party obtaining an order compelling discovery. Ind. T.R. 37(B)(2)(a). There is no basis to impose these sanctions here because no order compelling discovery was sought and such an order would not have been appropriate had it been sought. It is just as important to recognize, however, that opposing parties cannot meet their evidentiary burden by failing to pursue desired information in a timely manner (or at all) and then relying on the absence of this information to prove their point.

The second issue in dispute with regard to legal expense is the OUCC's contention that test year legal expense should be reduced by $147,124 to remove legal expenses associated with I&M's purchase of property from the City of Fort Wayne. The OUCC contends these expenses are non-recurring and not representative of future legal expenses since no evidence was presented that I&M engages in such transactions on an annual basis or expects to acquire any additional utilities. OUCC PO, at 210. The OUCC's position, however, misses the purpose of using a test year to establish I&M's revenue requirement. As the Commission has noted in the context of reviewing whether an insurance claim expense for a particular incident should be included in a utility's revenue requirement:

> [T]he ratemaking goal is not to determine whether specific claims paid will recur, but to set a reasonable ongoing level for [Injuries and Damages] expense. In a sense, all claims are non-recurring because of the myriad of facts that coalesce to result in one claim will not repeat. All claims have a degree of uniqueness. Therefore, merely because the facts of one claim will never specifically recur does not indicate that other perhaps equally unique claims will not occur during the years when Petitioner's

> rates are in effect. Therefore, the target is to set a reasonable level of expense for all claims that Petitioner will incur on a reasonable going level accrual basis during the life of the electric rates we are setting today. It is true that Actions A and B will not recur but other significant claims will probably occur requiring Petitioner's . . . expenditures to resolve them.

Southern Indiana Gas and Elec. Co., Cause Nos. 39871 and 40078 (IURC 6/21/1995) at 33-34.

Legal expenses share many characteristics with insurance claim expenses. The unique circumstances that give rise to litigation or transactions that require legal expertise in any particular year will not repeat because all have unique characteristics. The Commission's objective is to set a reasonable going level of expenses for all legal expenses I&M will incur on a reasonable going level accrual basis during the life of the electric rates. *Id.* at 34. In his sworn rebuttal testimony filed May 25, 2012, Mr. Krawec stated that I&M continues to incur legal expenses related to the implementation of the acquisition. Krawec Rebuttal, at 20. While I&M will not again acquire these particular assets, it may incur legal expense for acquisition of other utility property. Even if this is not the case, I&M will certainly incur future legal expenses for other types of transactions or litigation that did not occur during the test year. I&M witness Krawec's testimony that test year legal expense was the lowest of the most recent three year period demonstrates that the test year level of expense is already conservative. Krawec Rebuttal, at 20-21.

Ironically, the OUCC's Proposed Order establishes the flaw in its own argument. The OUCC responds to the evidence showing the consistency of test-year legal expense for the twelve month period before and after the test year by contending that "[t]his argument fails to acknowledge that the values of the two other twelve month periods . . . were not reviewed to determine whether those values included any amounts for outside legal expense that should likewise be considered non-recurring or otherwise inappropriate to include in rates." OUCCPO, at 209. The consistency in legal expenses over the three year period in the record demonstrates that each year tends to experience certain non-recurring costs that the revenue requirement should be set to recover.

I&M proposed in the alternative that the acquisition cost be amortized and recovered over a three year period. Krawec Rebuttal, at 21. The OUCC responds to that by asserting a determination may be required as to "whether such action would be permitted by the settlement agreements in Cause No. 43980." OUCCPO, at 210. The amortization proposed by I&M would not violate any of the settlement agreements in Cause No. 43980. This point is made clear by the OUCC's reticence to directly contend any provisions of the settlement agreements would be violated.

I. **Rate Case Expense.** The OUCC accuses Petitioner of "cherry-picking" with respect to the nuclear decommissioning study, but it is in fact the OUCC that is cherry-picking when it suggests blurring the line between the test year level and amortization of expenses benefiting more than one period. To propose that an expense be amortized means that one is proposing an adjustment to the test year level of expense. It then becomes incumbent to propose an adjustment which reflects an ongoing level of the expense rather than the test year amount. When a party proposes that an expense be amortized because it benefits multiple years, it is necessary that the entirety of that expense be included for amortization (not just the amount of the expense incurred during the test year) or else it is impossible for the Petitioner to recover the full amount of the expense.

The flaw in the OUCC's argument is most easily understood when considering rate case expense incurred after the close of the test year. An adjustment to the test year level is needed because the test year level is typically not representative; however, the estimated rate case expense included in the ultimate amortization is carried far beyond the test year all the way through the post-hearing schedule. Indeed, occasionally there will be an appeal from a rate order, in which event the costs of the appeal are eligible for recovery in the ensuing rate case. *Re Gary-Hobart Water Corp*., Cause No. 39585 (IURC 12/1/93) at 7. The expense incurred here – resulting from a requirement of a prior order and proceeding by a few months the beginning of the test year – is no less recoverable than the costs of appealing a prior rate order. It is improper to suggest that an expense be amortized and then limit the amount of the expense to be amortized to the amount incurred in the test year.

As to the amortization period, the OUCC requests, without citation to any record evidence, that the Commission should approve four years versus three. When amortizing rate case expense, the Commission has repeatedly stated that rate case expense should be amortized over the anticipated life of the rates in question. *See, e.g., Re Gary-Hobart Water Corp.,* Cause No. 39585 (IURC 12/1/93) at 6; *Re City of Carmel*, Cause No. 39536 (IURC 4/21/93) at 4-5. Petitioner's testimony that the life of the rates is three years is unrebutted.

J. **Nonrecurring Expenses.** The OUCC's characterization of various categories of expense as "nonrecurring" erects a standard that could essentially define the entirety of a utility's revenue requirement as being non-recoverable. As this Commission has "noted on several occasions, all expenses are to some degree non-recurring – that is, almost by definition, the same lawsuits and arbitration proceedings that were going on in the test year will not continue throughout the term that rates are in effect." *Re PSI Energy, Inc.,* Cause No. 40003 (IURC 9/27/96) at 77. If expenses are narrowly defined, such as attorney's fees related to a particular transaction, repair expense of a particular type of bolt, costs of a particular type of employee training, then literally all expenses are non-recoverable. That is not the test, however. Test year expenses must be viewed in terms of broad categories, *e.g.*, labor expense, O&M expense, legal expense. If the OUCC believes that a component of these broad categories incurred during the test year is non-recurring, the OUCC must then compare the total test year level to other years for purposes of determining whether the test year, in total, is representative of ongoing operations.

The OUCC's counter argument with respect to the bolts at the Cook plant actually supports I&M's position. OUCCPO, at 158. The OUCC contends that it is unfair to compare the test year level of repairs expense to prior years because perhaps there were other items of non-recurring expense in the prior year as well. This is precisely the point. I&M is not making the same repair each and every year because "all expenses are to some degree non-recurring." In total, the test year level of expense is representative of ongoing operations.

Moreover, the unfairness of the OUCC's overly narrow categorization of expense is further confirmed when juxtaposed against the alternative situation – an extraordinary expense outside of a rate case test year. The Commission has repeatedly adopted a stringent stance with respect to deferral requests associated with abnormal events between rate cases. *See, e.g., Re Duke Energy, Inc.*, Cause No. 43743 (IURC 10/19/11); *Re Indiana Michigan Power Co.*, Cause No. 40980 (IURC 11/12/98); *Re PSI Energy, Inc.*, Cause No. 39195 (IURC 2/26/92). With the OUCC's narrow definition, resulting in a pro forma level that is not representative of ongoing levels when compared to other years, under-recovery is virtually assured, because the pro forma level is lower than normal and the utility is denied deferral authority for future abnormal events.

K. <u>Alleged Non-Allowed Expenses.</u> The OUCC's approach, which is to eliminate the entire cost of whole departments or arbitrary percentages of departments, is not proper ratemaking. Instead, a review of individual expenses is required. *Re Indiana-American Water*

Co., Cause No. 44022 (IURC 6/6/12) at 70. I&M's explanation of its accounting coding was unrefuted and is essentially ignored in the OUCC's proposed findings. OUCCPO, at 157-58. Then, the OUCC asks the Commission to speculate that FERC and SEC reporting requirements "plausibl[y] . . . include . . . lobbying disclosures," despite Mr. Brubaker's rebuttal testimony to the contrary. Brubaker Rebuttal, at 9. The OUCC's position on alleged "non-allowed" expenses should be rejected.

L. <u>Workforce and Cost Reduction Initiative.</u> The OUCC, IG and SDI urge the Commission to deny I&M recovery of any of the approximately $30 million it invested as part of its Workforce Cost Reduction Initiative even though the investment generated $19.1 million in savings that will be reflected in the rates and charges approved in this proceeding. No party seriously disputes the disincentive that would be created by the resolution advocated by the OUCC, IG and SDI. I&M's expenditure of approximately $30 million during the test year has generated a reduction in the revenue requirement that would otherwise be required in this case. That is, the revenue requirement is lower by more than $19 million per year because of I&M's prudent management. Rather than encouraging utilities to make investments to achieve cost savings, requiring I&M to absorb this investment will penalize I&M for a benefit that inured to I&M's customers. Such a finding would discourage other utilities from making investments that inure to the benefit of their customers.

Perhaps implicitly recognizing the disincentive created by their position, the OUCC, IG and SDI contend that the result is fair because I&M has reaped sufficient savings to compensate it for making this investment. They compare the $30 million investment to the $19.1 million in savings that have accrued during the period between when the savings began and when new rates reflecting the reduced costs are expected to go into effect and conclude I&M recouped its investment. The analysis, however, is flawed. These parties wrongly compare the investment in workforce reduction against the resulting savings in a vacuum, ignoring other expenses incurred by I&M. Utilities cannot manage their business by segregating expense categories and pretending they can be matched to a previous revenue requirement. Utility regulation recognizes this, focusing on a utility's total return. *See* Ind. Code § 8-1-2-42.3. A utility manages its business to ensure total expenses are sufficiently less than total revenue to afford a return to shareholders for their investment. The focus on whether total workforce management savings off-set the necessary investment to achieve those cost savings is irrelevant. I&M was properly focused on whether its total revenues were sufficient. All parties to this proceeding have acknowledged that during the test year I&M's revenues were insufficient to generate reasonable returns for its shareholders.

Claiming that only I&M shareholders benefited from this investment is similarly an erroneous contention. For example, the OUCC contends that "the only beneficiaries of this work force reduction was [sic] the Company itself and its shareholders because before this order, any savings achieved were not and could not be reflected in I&M's rates [because] [p]rior to the issuance of this order, Petitioner's ratepayers did not see any decrease in their rates as a result of the workforce reduction." OUCCPO, at 162. It is true that I&M's customers did not experience a reduction in rates, but the savings produced other benefits for them. At a minimum, the savings enabled I&M to delay seeking an increase in its rates. The savings also provided funds for other expenditures and investments in I&M's business that benefit customers. No party disputes that I&M's earnings were less than its authorized return during the applicable period, demonstrating that the savings were used to continue funding other costs that had increased. The OUCC quotes from Mike Morris' announcement that the expense containment was necessary "to deliver continued value to shareholders, reward our hardworking employees and ensure adequate investment to deliver a reliable supply of affordable power to our customers." OUCCPO, at 163 quoting OUCC Cross-Examination Exhibit 47. The OUCC recognizes that Mr. Morris' statement acknowledged benefits to shareholders, but chose to ignore the benefits to customers that were also identified.

The OUCC responds to I&M's contention that the benefits of the cost reductions did not flow to shareholders by noting that "[a] public utility is not guaranteed its authorized return, but is merely afforded an opportunity." OUCCPO, at 163. I&M is not asserting that it is guaranteed a profit. I&M's earnings are relevant because they refute the contention made by other parties that the benefits of the cost reductions inured to shareholders. The workforce cost reductions were offset by other cost increases incurred by I&M to ensure reasonably adequate service to customers.

SDI references the decisions reached by the Ohio Public Utilities Commission and Virginia State Corporation Commission. In Ohio, the regulated AEP affiliate was permitted to amortize half of the workforce reduction costs while in Virginia the position of the OUCC, IG and SDI was adopted. This shows that some states understand the benefits that accrue to customers should be paid for by customers and act consistent with the Commission's finding that a utility "should not be penalized for efforts which clearly benefit the ratepayer prospectively." *Re Northern Indiana Pub. Serv. Co.*, Cause No. 38380 (IURC 10/26/1988) at 29.

VI. OFF SYSTEM SALES ("OSS") MARGINS SHARING MECHANISM

A. The Evidence Uniformly and Flatly Contradicts the OUCC's Assertion That the "OSS Margin Sharing Mechanism has Functioned as Intended." There is no evidence to support the OUCC's proposed finding that "the OSS margin sharing mechanism has functioned as intended." OUCCPO at 206. In fact, the evidence on this point was uniform and to the contrary.

The current OSS sharing mechanism was agreed to and approved in Cause No. 43306. In that case, test year OSS margins were $96 million. Order, Cause No. 43306, at 23. Projected OSS margins were at least $87.5 million. *Id.* Based on these numbers, the parties agreed to and the Commission approved an embedded credit of $37.5 million for OSS margins, with I&M and its customers sharing 50/50 the expected surplus OSS margins above this amount. Assuming OSS margins of $87.5 million as contemplated by the parties, customers were expected to receive a total of $62.5 million of these margins, or 71.4% of the total OSS margins realized.[29] I&M was expected to receive the balance of $25 million, or 28.6%.

But that is not what happened. As set forth in the testimony, the OSS margins generated by I&M for the years 2009 through 2011 varied from $32.9 million to $42.3 million. Blakley Direct, at 11. The following table shows the actual OSS margins during this period and the relative portions received by I&M and its customers:

Year	**Actual OSS Margins**	**OSS Margin Credit to Customers**	**Percentage of OSS Margins to Customers**	**OSS Margins to I&M**	**Percentage to I&M**
Assumption	$87.5 million	$62.5 million	71.4%	$25 million	28.6%
2009	$32.9 million	$37.5 million	114%	-$4.6 million	-14%
2010	$41.4 million	$39.5 million	95.4%	$1.9 million	4.6%
2011	$42.3 million	$39.9 million	94.3%	$2.4 million	5.7%
Total for 2009-2011	**$116.6 million**	**$116.9 million**	**100%**	**-0.3 million**	**0%**

[29] Calculated by adding the original credit of $37.5 million to 50% of the surplus realized: Total OSS margins to ratepayers = $37.5 million + (50% * ($87.5 million - $37.5 million)) = $37.5 million + (50% * $50 million) = $37.5 million + $25 million = $62.5 million.

As the above table demonstrates, there was no effective sharing of any OSS margins from 2009 to 2011. In fact, during that time period, the customers received ***more*** in OSS margin credits than I&M even generated. Customers received total credits of $116.9 million during this time period, but I&M generated only $116.6 million in actual OSS margins. Thus, I&M had a $300,000 deficiency with respect to OSS margins during this time period, and I&M did not get to share in ***any*** of the OSS profits, let alone the 28.6% the parties and Commission had envisioned when they entered into and approved the Settlement Agreement in Cause No. 43306.[30]

Contrary to the OUCC's proposed finding at page 206, the OSS margin sharing mechanism has ***not*** functioned as originally intended.

B. The OUCC's and the Intervenors' reliance on historical OSS margins ignores dramatic changes in the energy market and would defeat the purpose of the OSS margin tracker. The OUCC acknowledges – as it must – that OSS margins have fallen dramatically since Cause No. 43306. During the test year in that cause, OSS margins were $96.0 million. Test year OSS margins in this case were only $43.5 million. OUCCPO, at 207. Projected OSS margins for 2012 and 2013 are at or below the test year amount, and the OUCC did not challenge these projections. Blakley Direct, at 11.

Nonetheless, the OUCC proposes an embedded revenue credit for OSS margins that bears no relationship either to the original sharing mechanism established in Cause No. 43306 or to I&M's OSS projections. Instead, the OUCC has arbitrarily proposed to embed a revenue credit for OSS margins equal to the lowest level of OSS margins attained from 2007 – 2011. OUCCPO, at 207. Using this criteria, the OUCC proposes to embed a revenue credit of $32,908,567 – the OSS margins realized by I&M in 2009. OUCCPO, at 207. The Intervenors

[30] The above table is consistent with the testimony from Mr. Krawec, who testified that I&M generated OSS margins of $109,128,889 from March 23, 2009, through December 31, 2011, but that it provided a credit to its customers of $109,248,407 during this same period, for a loss of $120,000. Krawec Direct at 13.

generally agree with the OUCC's proposal.

The OUCC has not provided any evidence that the OSS margins realized in 2009 bear any relationship whatsoever to the OSS margins that will be available to I&M on a going forward basis. For example, I&M's witnesses explained that it generates OSS margins through both traditional and non-traditional activities and that the traditional and non-traditional OSS markets have changed dramatically over the last several years due to numerous factors, including the economic downturn, environmental regulations, and drastic declines in the price of natural gas relative to coal. Pascarella Direct at 9-13; Tr. H-123; Brady (Adopted Busby) Rebuttal, at 2-3. All of these factors have negatively affected I&M's ability to generate OSS margins when compared to the highs experienced in fiscal years 2007 and 2008. Yet the OUCC has not factored these changes into its proposal.

Nor has the OUCC done any analysis to compare these changes and their likely effects to the conditions that existed in 2009, the year the OUCC has selected as its baseline for setting a new OSS margin revenue credit. For example, the OUCC has

- Not compared 2009 natural gas prices to projected natural gas prices going forward;
- Not compared 2009 coal prices to projected coal prices going forward;
- Not compared energy demand in 2009 to projected demand going forward;
- Not compared the supply and relative costs of alternative fuels in 2009 to projected supplies and relative costs going forward;
- Not compared the level of environmental regulation in 2009 to projected levels of environmental regulation going forward;
- Not compared general economic indicators in 2009 with the projected economic indicators going forward;

- Not compared relative volatility levels for the price of natural gas in 2009 to projections of the relative volatility levels for the price of natural gas going forward;

- Not compared the opportunities for non-traditional OSS margins in 2009 to the projected opportunities going forward; and

- Not compared the volatility of wholesale markets for electricity in 2009 to the projected volatility going forward.

Without such comparisons, there is no rational basis to believe that the OSS margins realized in 2009 reveal anything about what OSS margins are likely to be going forward. Any attempt to use 2009 OSS margins as a predictor of OSS margins in 2012, 2013 or any other year going forward without a comparison of the underlying factors driving OSS margins during the years in question would be nothing but sheer speculation. And speculation is not a proper basis on which to support the OSS sharing mechanism or any other aspect of the Commission's order.

The Commission should reject the OUCC's proposal for another reason – embedding any significant revenue credit for OSS margins runs the risk of defeating the very purpose of the tracking mechanism. The Commission has previously determined that tracking mechanisms are appropriate where an expense or source of revenue is substantial, volatile and largely outside of the control of the utility.

I&M's proposal removes the arbitrarily set revenue credit for OSS margins. Under I&M's proposal, customers will receive 50% of the actual OSS margins generated by I&M. There is no need to try to project OSS revenues going forward or to try to predict how the OSS market will change from one year to the next because I&M's proposed methodology does not attempt to predetermine I&M's OSS margins. Customers will receive 50% of whatever OSS margins are available in any given year, and I&M will have every incentive to maximize these margins because it will receive the remaining 50%. I&M's proposed OSS methodology is fair and balanced, and it completely avoids the risks of arbitrary and unintended results inherent in the OUCC's proposal. Contrary to the OUCC's statement at page 209 of its proposed order, it is I&M's method – not the OUCC's method – that "guarantees a pre-defined and equitable level of sharing between the parties…."[31]

C. <u>The OUCC's proposal ignores the distinction between traditional and non-traditional OSS activities, and it ignores the evidence that I&M's non-traditional activities distinguish it from other Indiana electrical utilities.</u> The OUCC's proposed order inappropriately ignores the distinction between OSS margins generated through traditional activities and those generated through non-traditional activities. This distinction is important because the risk profiles between the two and the Commission's jurisdiction over them are fundamentally different.

As explained by I&M's witnesses, traditional OSS margins result from the sale of excess power into the wholesale market. If a utility is meeting available customer demand at less than full capacity, it can use its physical assets to generate and sell excess power into the OSS market. Profits from these sales contribute towards the utility's OSS margins. These margins are generated using physical assets owned by the utility that are included in its rate base and on which it earns a return. Thus, because the Commission wants to encourage the utility to optimize use of these physical assets, the Commission considers it appropriate to institute a system that penalizes the utility for failing to do so. This was the genesis of the OSS sharing mechanism that the Commission has implemented in previous utility rate cases.

However, non-traditional OSS margins are different. Non-traditional OSS margins are not connected to the power generation assets or the sale of excess power. Instead, non-

[31] The OUCC's statement to the contrary is remarkable. Under the OUCC's proposal, nobody knows what level of sharing – if any – will result in any given year. There is nothing "guaranteed" or "pre-defined" under the OUCC's proposal.

traditional OSS margins are generated primarily through pure financial transactions such as auctions, "booked out" transactions, basis trading, time-spread trading, spark spread trading, and hedging. These financial transactions – like stock market transactions – are only possible if the trading participant is willing to assume the risk of loss on the transaction if it goes badly. And I&M and its shareholders are the ones putting their money at risk in these transactions – not the customers. If a non-traditional transaction goes badly, I&M and its shareholder will suffer the loss – not the customers.

The OUCC has argued that there is no difference between traditional and non-traditional OSS margins because the customers, through rates, effectively pay the salaries of the traders and a return on the desks, computers and other physical assets used to conduct the trading. But, of course, these physical assets are not the assets that create the value of the non-traditional OSS margin. As a simple example, if an employee uses the company's computer to access his E-Trade account and buy 100 shares of Apple stock, if that stock triples in value, it wasn't the $1,200 laptop that generated the return on the investment. The returns were instead created by the employee's willingness to risk the cash that he used to buy the stock.

I&M's non-traditional OSS margins are similar. The value created by these non-traditional activities is not the result of the $800 desktop computer or the desk used by the employee who conducts the trade. The value is created by the risk I&M assumes when it uses its cash to participate in the financial transaction. Thus, the OUCC is simply wrong when it states that the non-traditional OSS financial transactions "would not be possible without the use of other I&M[] assets…[that] are supported by customers in the form of a return on and a return of these assets." OUCCPO, at 209. I&M could conduct these transactions using employees, office space and computers that are not supported by customers. But, just as importantly, any contribution from using such employees, office space and computers is negligible and wholly unrelated to the value created through those transactions.

In addition to ignoring this vital difference between traditional and non-traditional OSS margins, the OUCC also misstates the record when it asserts that I&M's non-traditional transactions are similar to those of other Indiana investor-owned electric utilities. OUCCPO, at 208-09. In fact, that was not the evidence. Mr. Chodak testified that AEP could separate the traditional and non-traditional wholesale market activities conducted by its Commercial Operations group, as other utilities have done, into a stand-alone business and manage that activity for the sole benefit of its shareholders. Chodak Direct, at 17. Mr. Pascarella testified that other Indiana utilities are focused just on serving retail load and have a separate entity that is deregulated to generate the wholesale margins. Tr. H-126. Mr. Brady testified that the source of I&M's OSS margins distinguishes it from other Indiana utilities OSS sales. Brady (Adopted Busby) Rebuttal at 10-11.

Thus, the evidence before the Commission is directly contrary to the OUCC's assertion that its failure to distinguish between traditional and non-traditional OSS margins is consistent with the Commission's treatment of all other Indiana electric utilities. In fact, the evidence shows that I&M's non-traditional trading activities distinguish it from the other Indiana investor-owned electric utilities, and its OSS sharing mechanism should recognize this distinction.

D. The OUCC's proposal for sharing of OSS margins above – but not below – the embedded credit is unfairly punitive. In addition to proposing an embedded revenue credit for OSS margins, the OUCC also proposes a sharing mechanism that would force I&M to assume 100% of the risk that the arbitrary credit the OUCC has selected will be inaccurate.

According to the OUCC's proposed order, "symmetry is not a requirement in setting rates," and "[i]t is not imperative for revenues to equal expenses." OUCCPO, at 208.

These are remarkable statements.

This Commission has recognized on multiple occasions that utility rates must be set at a level that allows the utility both to recoup the reasonable costs of providing service and to earn a reasonable rate of return on its investment. As explained in the venerable Phillips text (The Regulation of Public Utilities (3rd ed.)) at 176:

> The basic standard of rate regulation is the revenue-requirement standard, often referred to as the rate base-rate of return standard. Simply stated, a regulated firm must be permitted to set rates that will both cover operating costs and provide an opportunity to earn a reasonable rate of return on the property devoted to the business.

Thus, contrary to the OUCC's assertion, there is a symmetry requirement. Rates must be set at such a level so that revenue at least equals – or, more accurately, exceeds – the reasonable expenses of operating the utility.

Here, the parties agree that OSS margins in any given year will vary based on factors completely outside of I&M's control. Neither the OUCC nor IG can predict with any level of certainty whether the OSS margins generated by I&M in any given year will surpass the amount of the embedded credit they propose, which is based on the OSS margins I&M generated in 2009. Thus, neither the OUCC nor IG can predict with any level of certainty whether I&M's projected revenue under their proposal will be sufficient to cover the reasonable costs of operating the utility and provide I&M was a reasonable rate of return.

Given the above, there is no reasonable basis for the OUCC's and IG's proposal to force I&M to bear 100% of the risk that actual OSS margins will be less than the 2009 margins these other parties seek to embed as a revenue credit. As all parties have recognized, I&M is incentivized to maximize OSS margins because of the potential for it to share in at least a portion of these revenues. If, despite this incentive, I&M is unable to generate OSS margins that exceed the embedded credit, any such deficiency would be due solely to market factors outside of I&M's control. Thus, there would be no equitable basis for – and no additional incentive to be gained by – forcing I&M to absorb the entire deficiency.

In fact, a strong case can be made that the customers should bear 100% of the risk of any deficiency because to do otherwise would provide the customers with a windfall. Under the OUCC's proposal, if the revenue credit exceeds actual OSS margins in any year, the customers continue to receive the full credit, even though the OSS margins embodied in that credit did not materialize. The customers therefore would pay less in rates than the actual cost of retail service, even though the decreased OSS margins were not I&M's fault. The same would be true even if I&M shares in 50% of the deficiency.

Nonetheless, if the Commission accepts the OUCC's and IG's proposal to embed in rates a revenue credit for OSS margins, I&M asks that the Commission implement a sharing mechanism allowing it and the customers to share both any surplus and any deficiency on a 50/50 basis.[32]

E. <u>If the Commission decides it can embed a revenue credit of OSS margins, it should base the credit on I&M's projections, and it should recognize the distinction between traditional and non-traditional margins.</u> I&M believes that its proposal for sharing OSS margins 50/50 with its customers from the first dollar is the most equitable and provides

[32] In Cause No. 43306, I&M agreed to a sharing mechanism under which it had to absorb 100% of any deficiency below the embedded credit of $37.5 million. I&M agreed to this as part of the overall settlement and because the embedded credit had been set at a level much lower than the anticipated OSS margins going forward. If the Commission adopts the OUCC's proposal to include the proposed $32.9 million embedded credit – a credit that approximates or exceeds projected OSS margins – I&M would no longer be willing to voluntary accept 100% of this risk.

sufficient incentive for I&M to maximize OSS margins. However, if the Commission decides it may lawfully embed a revenue credit for OSS margins, the embedded credit should be based on projected OSS margins going forward and with the important distinction between traditional and non-traditional OSS activities in mind.

I&M suggests that the following data may be useful to the Commission when considering any embedded credit requirement:

- The OUCC proposes using 2009 as the benchmark year. In 2009, $21.7 million of the $32.9 million in OSS margins were generated through trading activities as part of I&M's non-traditional OSS transactions. Excluding these non-traditional margins, the revenue credit would be $11.2 million.[33]

VII. TRANSMISSION SERVICE

The OUCC incorrectly objects to I&M's proposed treatment of certain transmission-related cost components on the grounds that the Company did not provide "any information" showing that the current mechanism harmed its ability to serve customers or offer "persuasive arguments" why transmission revenues and expenses should be omitted from basic rates. OUCCPO, at 210. The Company provided testimony, exhibits and workpapers establishing the merits of its proposal and also discussed, made presentations, and provided information during the audit process and in response to discovery in support of the Company's proposed inclusion of transmission costs under the PJM Open Access Transmission Tariff ("OATT"). IMPO, at 210, Roush Direct at 23-24; Roush Rebuttal, at 15-16; IIMPO, at 184-185. Specifically, Mr. Roush

[33] The Industrial Group asserted at page 59 of Attachment A to its Exceptions to I&M's Proposed Order that, "during questioning from the bench, it was established that one of the Cook nuclear units was down a significant part of 2009, which would have impacted the total I&M generation available that year." That was not the testimony. As explained by multiple witnesses, OSS margins are generated through the Commercial Operations business unit of AEPSC, and I&M shares in the OSS margins generated with the other affiliated members of the AEP Interconnection Agreement based on its Member Load Ratio. Pascarella Dir. at 3-4. I&M would be allocated OSS margins under this system, even if it did not have any power plants operating on a given day. Tr. CC-117. And when asked specifically whether the absence of Cook would have impacted the level of traditional OSS margins in 2009, Mr. Busby answered: "No…." Tr. FF-9.

provided the following rationale in support of the Company's proposal that its transmission costs should be based upon the charges under the PJM OATT:

- I&M no longer has exclusive control over its transmission costs because of its membership in PJM;
- Comparability in transmission charges with other Indiana customers in the AEP zone who pay the FERC-approved;
- Proper separation of I&M's costs to provide retail electric service as a load serving entity ("LSE") from I&M's costs and wholesale revenues as a transmission owner ("TO"); and
- I&M is charged for transmission service regardless of facility ownership.

Roush Direct at 23-24, IMPO, at 184-185. Mr. Roush further explained that the Company's proposal better reflects the transmission service costs I&M incurs as an LSE. *Id.* These cited factors demonstrate that the Company's proposal properly reflects that there has been a shift in the manner in which transmission costs are determined and handled. The Company's proposal properly recognizes the manner in which transmission costs now arise and would ensure that customers pay no more or less than the actual cost of transmission service. Roush Rebuttal at 14; IMPO, at 185. Thus, the "compelling evidence" the OUCC seeks at page 210 of its proposed order has, in fact, been provided by I&M and the Company's proposal should be adopted.

Moreover, the OUCC's notion that there is no evidence why the Commission should take an approach that no other Indiana utility has sought is nonsensical. OUCCPO, at 211. Taken to its logical conclusion, under the OUCC's theory, nothing new or different could ever be proposed in Indiana because whoever proposes it will always be met with the response that no one has ever asked for this and we need to wait until others do. Proposals should be considered on their merits, not with undue consideration to whether a proposal has been made by others, as the OUCC suggests in this instance.

The IG concurred with the Company's proposal to include FERC-approved OATT charges in basic rates. IGE at 61-62. Additionally, the Company's Proposed Order included language expressly stating that adoption of the Company's proposal should not be interpreted as the Commission relinquishing its ratemaking authority over the transmission component of I&M's retail rates in Indiana. IMPO, at 185. I&M included this language to address the IG's concern (Dauphinais Direct, at 12) that adoption of the Company's proposal could be so viewed and that such language expressly stating that jurisdiction was not ceded should be included. Dauphinais Direct, at 16; IGE, at 61-62. With the inclusion of this language, no dispute exists between the Company and the IG on this issue.

VIII. COST OF SERVICE METHODOLOGIES

A. Demand Allocation Methodology. Both I&M and the IG agree that the 6 CP demand allocation factors should continue to be used by I&M. IMPO, at 155; IGE, Section 13(A)(7) at 2. The OUCC's Proposed Order abandons the OUCC's Peak and Average approach in favor of its alternative proposal for a 12 CP allocation method. OUCCPO, at 173. The continued use of the 6 CP methodology is supported by the undisputed load data, which reflects six monthly peaks. IMPO, at 153. Given the paucity of evidence in support of a 12 CP methodology, the Commission should adopt I&M's proposed findings.

B. Transmission and Distribution Plant Allocation Methodology. Fort Wayne and IG propose I&M use the minimum system distribution ("MDS") methodology to allocate a portion of plant accounts 364 through 368 as customer-related. FWE at 8-13; IGE, Section 13(A)(7) at 3-5. The OUCC disagrees with the MDS methodology and proposes that transmission, sub-transmission and primary distribution plant should be allocated using a 12 CP methodology. OUCCPO, at 174-75. I&M's proposal to allocate transmission and distribution plant as 100% demand-related using its 6 CP and secondary demand allocation factors reasonably balances the interests of the parties, is supported by I&M's standard engineering practice, and should be adopted by the Commission.

IX. RATE DESIGN

A. Voltage Differentiated Fuel Factors. Both I&M and the OUCC agree that I&M should not implement voltage-differentiated fuel factors in I&M's FAC proceedings. IMPO, at 159; OUCCPO, at 178. In their exceptions, SDI and the IG propose the Commission require I&M to adopt a voltage-differentiated FAC. SDIE at 177-78; IGE at 55-56. As recognized by the OUCC, there was limited evidence in this proceeding as to how a voltage-differentiated fuel factor would be implemented in I&M's FAC. IMPO, at 158. Accordingly, I&M's PO should be adopted by the Commission.

B. LGS Rate Schedule. In its Proposed Order, Kroger recommends the demand charges for LGS Secondary and Primary should be set to recover 65% of demand-related costs, while demand charges for LGS Subtransmission should be set at 70% of demand-related costs. KrogerPO at 3. However, as explained by I&M Witness Roush, Kroger's proposal could result in lower load factor customers within the class subsidizing higher load factor customers. Tr. H-22-23. The record reflects that I&M modified its proposed LGS rate design to more equally distribute the rate increase among lower and higher load factor LGS customers. IMPO, at 160; Tr. H-23. Accordingly, I&M's Proposed Order balances the interests of the various LGS class customers and should be adopted by the Commission.

C. Tariff, Rules and Regulations.

1. Employee Discounts. Although the OUCC proposes that I&M's pro forma revenue requirement not include the costs associated with employee discounts (OUCCPO

at 194-95), no party disputed that I&M's employee discount is a tax-free fringe benefit that costs less from a ratemaking perspective than alternative forms of compensation. The record demonstrates that I&M's employee discounts are a reasonable expense and consistent with standard utility practice. IMPO, at 167-68. The Commission should reject the OUCC's proposed findings on this point.

2. Senior Citizen Tariff. The OUCC proposes that I&M submit a proposal for a limited pilot program in a separate proceeding. OUCCPO, at 195. This would needlessly delay implementation of the Senior Citizen Rate. The record reflects that I&M has modified its proposal to address the concerns raised by the OUCC regarding this tariff. *See* IMPO at 168; Tr. EE-55-58. Accordingly, the Commission should approve the modified Senior Citizen Tariff set forth in Petitioner's Exhibit WWH-R1.

3. Term and Conditions 11 and 12. In its Proposed Order, the OUCC asserts that the Commission should remove language that has existed in I&M's tariff for decades and which the record reflects is standard industry language. OUCCPO, at 195-96; IMPO, at 169. The OUCC's argument that this language goes beyond the scope of the Commission's jurisdiction is unsupported by the record and should not be accepted by the Commission.

4. Term and Condition 16. I&M proposed clarifying language to Tariff T&C 16 to eliminate confusion and reflect I&M's existing practice of siting utility equipment and facilities consistent with good engineering practices. While the OUCC alleges this change amounts to an "erosion" of rights, OUCC Witness Hand admitted during cross-examination that I&M's existing tariff language was unclear. OUCCPO, at 196; Tr. X-40. The undisputed evidence shows that I&M's proposed language is typical in the industry (IMPO at 171-72) and accordingly the Commission should adopt I&M's Proposed Order.

5. Terms and Conditions 12 and 17. The OUCC recommends rejection of the clarifying language proposed by I&M for Terms and Conditions 12 and 17 and recommends that I&M mirror the Commission's language in 170 IAC 4-1-16(b). OUCCPO, at 196. That language is already contained in Term and Condition 5. *See* Petitioner's WWH-1, pp. 15-16. The record demonstrates that I&M's proposal merely clarifies existing company practice. IMPO, at 169. The parties presented no evidence in opposition to this assertion and the Commission should approve Terms and Conditions 12 and 17 as proposed by I&M.

6. Tariff CS-IRP and CS-IRP2. In its proposed order, the OUCC incorrectly states that the process currently used by I&M for its Tariff CS-IRP2 filings does not provide sufficient time for parties to review the filing and determine whether to file an objection. OUCCPO, at 196-98. Indeed, Cause No. 43878 itself, which related to a special contract filed pursuant to Tariff CS-IRP2, demonstrates that the current process adequately allows for objections to be filed and for docketed proceedings to be conducted when necessary. The OUCC's citation to the Commission's Order in Cause No. 43839 is a *non sequitur*. That language solely related to how to present special contract information in the context of a cost-of-service study, where confidential customer-specific information might be revealed. It did not address whether the 30-day filing process would be appropriate for special contract filings. The Commission should reject the OUCC's collateral attack on its prior orders in Cause No. 43878 and 43306 and reject the OUCC's proposed finding.

7. Tariff R.S.-OPES. The OUCC recommends the Commission reject I&M's proposed changes to Tariff R.S.-OPES and encourage I&M to present the proposed tariff in a separate proceeding. OUCCPO, at 198. Contrary to the OUCC's assertions, there has been ample opportunity for interested parties to review I&M's proposed changes to Tariff R.S.-OPES

in this proceeding. Moreover, the evidence reflects that I&M has modified its proposal to address the concerns raised by the OUCC. IMPO, at 169-70; Tr. EE-62. Re-litigating these issues in a separate proceeding would only increase the administrative burden on interested parties and delay implementation of this innovative program. I&M's Proposed Order findings regarding Tariff R.S.-OPES should be adopted.

8. "Green Energy" Subdocket. In their Exceptions, South Bend and Inovateus propose that the Commission initiate a subdocket to address a variety of potential renewable energy mechanisms, including a green-energy tariff, a feed-in tariff or a purchased power agreement. SBE at 5-6; InovateusE at 12-13. No party proposed this in their prefiled testimony, nor is there any record evidence to support this proposal. To the contrary, the record demonstrates that I&M uses a diverse and integrated portfolio of supply-side and demand-side resources to provide retail electric service. Torpey Rebuttal, at 10-11; Roush Rebuttal, at 17; Rider NMS (Net Metering Service Rider); Rider COGEN/SPP; ; Rider D.L.C.-2; Rider R.P.R.; Rider D.R.S.1; Rider D.R.S.2; Tariff R.S.-OPES; Tariff R.S.-TOD; Tariff R.S.-TOD2; Tariff G.S.-TOD; Tariff G.S.-TOD2; Tariff L.G.S.-TOD; Tariff C.S.-IRP; Tariff C.S.-IRP2; Tariff RTP. The record demonstrates that solar energy is not cost effective. Torpey Rebuttal, at 9-10; Roush Rebuttal, at 18; Tr. GG 72-74, 81-83. Furthermore, such matters fall outside the scope of this retail rate proceeding. Moreover, Commission proceedings are not free. They impose costs on the utility, the Commission and other stakeholders. Accordingly, the Commission should not adopt South Bend's and Inovateus' proposed findings.

CONCLUSION

The evidence is undisputed that I&M is not earning a fair return. The requirement to determine a fair value rate base, and to provide a fair return thereon, is grounded both in sound economic principles and the basic tenets of private property and fundamental fairness, expressed in both the federal and the Indiana constitutional requirement of reasonable compensation for the public use of any citizen's property. *E.g.*, *Board of Public Utility Commissioner's v. New York Telephone* Company, 271 U.S. 23, 31, 32 (1926). Fundamental fairness, sound regulatory policy, and the U.S. Supreme Court decisions in *Hope* and *Bluefield* require the Commission to provide I&M a realistic opportunity to earn its authorized return through the rates established for the provision of retail service.

The OUCC and Intervenor proposals contravene these and other well established legal and regulatory requirements and ignore or distort substantial probative evidence. They urge the Commission to exclude reasonable and necessary costs for providing service, to ignore the fact that the current value of I&M's utility property exceeds its net original cost, to ignore the benefits customers have received from I&M's efforts to reduce its costs, to award a confiscatory return, and to force I&M to earn its return on retail service through the competitive and volatile wholesale market. Their proposals jeopardize I&M's financial integrity, its compliance with federal and other regulatory mandates and the continued provision of safe, reliable and economic service. This in turn harms customers and the public interest. "[T]he power to regulate is not the power to destroy, and the limitation which the Public Service Commission may impose upon public utilities in the fixing of rates and charges is not the equivalent of confiscation." *Public Service Comm. v. Indiana Bell Telephone Co.*, 235 Ind. 1, 130 N.E.2d 467, 481 (1955).

Therefore, for the reasons set forth in I&M's testimony, exhibits and post-hearing filings and to comply with Indiana law and further the public interest, I&M respectfully urges the Commission to adopt the findings in I&M's Proposed Order and promptly issue an order approving the rate increase sought by I&M.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that the foregoing Petitioner's Reply Brief in Support of Proposed Order was served this 13th day of September, 2012, via email transmission to:

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